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IN THE

Supreme Court of the United States

OCTOBER TERM, 1959

No. 387

AMERICAN TRADING AND PRODUCTION CORPORATION,
Petitioner

v.

RAILROAD COMMISSION OF TEXAS, PHILLIPS PETROLEUM COMPANY, JOSEPH I. O'NEILL, JR., AND MURPHY H. BAXTER, *Respondents*

PETITION FOR A WRIT OF CERTIORARI

To The Court Of Civil Appeals For The Third Supreme Judicial District of Texas At Austin

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INDEX

Page

Opinions below 1

Jurisdiction 2

Questions presented 2

Constitutional provision, statute, and regulations involved 4

Statement of the case 4

Reasons for granting the writ 12

1. The lower court's decision is of widespread importance because it seriously impairs the rights of owners of small tracts in undeveloped gas and oil fields who lease or "farm out" their tracts to have them drilled and developed. It denies constitutional protection to the retained property rights of such owners. Thus it greatly reduces the utility of these property interests in future gas and oil transactions, and it deprives great numbers of persons owning such property interests in small tracts of all protection against serious dangers from which the owners were previously secure .. 12

2. The lower court's decision directly conflicts with the decision of this Court in *Pennsylvania Coal Co.* v. *Mahon* and *Thompson* v. *Consolidated Gas Utilities Corp.*, both of which are fundamental to the law of gas and oil regulation. It conflicts with the *Pennsylvania Coal* decision because it upholds regulatory action which deprives petitioner of its *entire* property right without compensation and transfers it to another, rather than simply *restricting the enjoyment* of the right. It conflicts with the *Thompson* case because it approves the taking of petitioner's property right without compensation where there is a complete lack of any public purpose to justify the action. It is also contrary to other decisions of this Court dealing with the taking of private property without compensation and to decisions concerning the equal protection of the laws 18

Page

The alternative disposition 27

Conclusion 29

Appendix A:

Constitutional provision 1a
Statute 1a
Regulations 5a

Appendix B:

Motion of appellee for rehearing, Texas Court of Civil Appeals 7a
Application for writ of error, Supreme Court of Texas 9a

Appendix C:

Opinion of Texas Court of Civil Appeals 11a
Judgment of Texas District Court 26a
Special Order of Railroad Commission of Texas ... 28a

Appendix D:

Judgment of Texas Court of Civil Appeals 31a
Order of Texas Court of Civil Appeals on rehearing 32a

CITATIONS

Cases:

Block v. Hirsch, 256 U.S. 135 25
Caruthers v. Leonard, 254 S.W. 779 (Tex. Com. App.) 14
Champlin Refining Co. v. Corporation Commission, 286 U.S. 210 18
Cities Service Gas Co. v. Peerless Oil and Gas Co., 340 U.S. 179 18
Cumberland Coal Co. v. Board of Revision, 284 U.S. 23 27
Hairston v. Danville & W. R. Co., 208 U.S. 598 17
Herb v. Pitcairn, 324 U.S. 117 ..... 27, 28, 29

Page

International Paper Co. v. United States, 282 U.S. 399 24
James v. Dalhart, 254 S.W. 2d 826 (Tex. Civ. App.) 14
Loftus v. Illinois, 334 U.S. 804 ..... 27, 28, 29
Mills v. Brown, — Tex. —, 316 S.W. 2d 720 (Tex. Sup. Ct.) 4
Miller v. Schoene, 276 U.S. 272 25
Minnesota v. National Tea Co., 309 U.S. 551 29
Morey v. Doud, 354 U.S. 457 27
Naim v. Naim, 350 U.S. 891 29
Ohio Oil Co. v. Indiana, 177 U.S. 190 ..... 18, 20
Patterson v. Alabama, 294 U.S. 600 29
Pennsylvania Coal Co. v. Mahon, 260 U.S. 393 ..... 17, 18, 19, 20, 21, 24, 25
Perry v. Smith, 231 S.W. 340 (Tex. Com. App.) 14
Railroad Commission v. Rowan & Nichols Oil Co., 310 U.S. 573, 311 U.S. 570 18
Railroad Commission of Texas v. Humble Oil & Refining Co., 151 Tex. 51, 245 S.W. 2d 488 (Tex. Sup. Ct.) 5, 7, 26
Sheffield v. Hogg, 124 Tex. 290, 77 S.W. 2d 1021 (Tex. Sup. Ct.) 4, 14
Sid Westheimer Co. v. Piner, 263 S.W. 578 (Tex. Com. App.) 11
Smith v. Cahoon, 283 U.S. 553 27
Texas Co. v. Railroad Commission of Texas, 246 S.W. 2d 487 (Tex. Civ. App.) 5, 7, 26
Thompson v. Consolidated Gas Utilities Corp., 300 U.S. 55 ..... 18, 23, 24, 25
United States v. Causby, 328 U.S. 256 21
United States v. Central Eureka Mining Co., 357 U.S. 155 ..... 21, 24, 25
United States v. Kansas City Life Ins. Co., 339 U.S. 799 21
Watts v. City of Houston, 196 S.W. 2d 553 (Tex. Civ. App.) 14
Williams v. Georgia, 349 U.S. 375 29

CONSTITUTIONAL PROVISIONS:

Fourteenth Amendment, Section 1, Constitution of the United States 4, 18, 19, 25

Page

STATUTES:

Vernon's Annotated Civil Statutes, Article 6008:

§ 1 ..... 4, 5
§ 6 ..... 4, 5
§10 ..... 4, 5, 22
§11 ..... 4, 5
§12 ..... 4, 5, 9, 22
§13 ..... 4, 5, 23
§14 ..... 4, 5
§16 ..... 4, 5

REGULATIONS:

Railroad Commission of Texas, Special Order No. 8-36, 924, November 21, 1957, Rule 1 ..... 4, 26

Railroad Commission of Texas, Special Order dated May 29, 1934 ..... 4, 10

MISCELLANEOUS:

24 Am. Jur. 545 (Gas and Oil § 39) 4, 14

Summers on Oil and Gas:

Vol. 1A, p. 89 9
Vol. 1A, p. 90 ..... 9, 23
Vol. 1A, § 97 ..... 22, 23
Vol. 2, p. 317 14

3B Tex. Jur. 261, (Appeal and Error § 859) 11

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PETITION FOR A WRIT OF CERTIORARI

To The Court Of Civil Appeals For The Third Supreme Judicial District of Texas At Austin

Petitioner prays that a writ of certiorari issue to review the judgment of the Court of Civil Appeals for the Third Supreme Judicial District of Texas, entered in the above-entitled case on April 1, 1959. In the alternative, petitioner prays that a writ of certiorari issue and that this case be remanded for consideration of the federal constitutional questions present in the case.

OPINIONS BELOW

The order of the Railroad Commission of Texas, Oil and Gas Division, denying the application of petitioner for permission to develop and protect its gas and oil mineral rights in certain lands by drilling a well thereon is unreported and is printed in Appendix C hereto, p. 28a, *infra*. The judgment of the District Court for

the 53rd Judicial District of Texas setting aside the order of the Railroad Commission, also unreported, is printed in Appendix C at p. 26a, *infra*. The opinion of the Court of Civil Appeals for the Third Supreme Judicial District of Texas, reversing the District Court, is printed in Appendix C, *infra*, at p. 11a, and reported at 323 S.W. 2d 474.

JURISDICTION

The judgment for which review is sought was rendered by the Court of Civil Appeals, Third Supreme Judicial District of Texas, on April 1, 1959. Rehearing was denied April 22, 1959. Application for writ of error in the Supreme Court of Texas was denied on June 17, 1959. A rehearing in that court was requested on June 30, 1959, and denied on July 29, 1959.

The jurisdiction of this Court is invoked under 28 U.S.C. § 1257(3).

QUESTIONS PRESENTED

Petitioner was the owner of gas and oil rights in two adjoining tracts in Texas. It "farmed-out" its rights to a large gas and oil operator. The operator was obligated to drill a well on each tract. Petitioner retained the right to drill in case the operator failed to do so within a specified time. Petitioner's retained right was a property right under state law. This type of "farm out" arrangement is a widespread practice, often used by ranchers or small property owners who enter into such agreements with operators who are financially able to drill wells and are willing to take the risks. Typically, these operators have or obtain other interests in the same field and are in a position to capture the gas and oil underlying the "farmed out" land through their other wells. This is a basic reason

why the "farm out" agreements obligate the operator to drill a well within a specified time, and preserve the right of the original owner to drill if the "farm out" operator does not do so as specified.

The operator drilled on one tract but failed to do so on the second, and petitioner thus regained its entire interest therein. Before the operator's allotted time had elapsed, however, the Railroad Commission of Texas established Field Rules prescribing minimum acreage for drilling wells. To avoid confiscation of the interest of persons with mineral rights in tracts smaller than the minimum size, the Commission's rules permitted drilling on any such tract if the tract or any interest therein existed under separate ownership prior to the new rules.

The Commission denied petitioner permission to drill on its undrilled tract in spite of the fact that its retained property right in the tract existed prior to the new rules. In effect, the Commission held that its rules did not protect the property interest retained by the original owner in the "farm out" agreements.

The questions presented are:

1. Was the Commission's application of its new well-spacing rules in a way which deprived petitioner of all opportunity to enjoy its valuable pre-existing property right a taking of petitioner's property in violation of the due process clause of the Fourteenth Amendment?

2. Was the Commission's refusal to protect petitioner's pre-existing property right, even though the Commission's rules were worded and conventionally applied to protect all pre-existing property rights, a denial of equal protection in violation of the Fourteenth Amendment?

CONSTITUTIONAL PROVISION, STATUTE AND REGULATIONS INVOLVED

1. Constitution of the United States, Amendment 14, Section 1.

> "nor shall any State deprive any person of life, liberty, or property, without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws."

2. Vernon's Annotated Civil Statutes, Article 6008, §§ 1, 6, 10, 11, 12, 13, 14, 16.

Printed in Appendix A, p. 1a, infra.

3. Railroad Commission of Texas, Special Order No. 8-36, 924, Adopting Operating Rules for the Azalea (Strawn) Field, Midland County, Texas, Effective November 21, 1957.

Rule 1

Printed in Appendix A, p. 5a, infra.

4. Railroad Commission of Texas, Special Order Dated May 29, 1934, Regarding Application of Rule 37.

Printed in Appendix A, p. 6a, infra.

STATEMENT OF THE CASE

Under the law of Texas, gas and oil and other minerals in place are real property.[1] A gas and oil lease transfers to the lessee a determinable fee in the gas

[1] *Mills* v. *Brown*, — Tex. —, 316 S.W. 2d 720 (Tex. Sup. Ct. 1958); *Sheffield* v. *Hogg*, 124 Tex. 290, 77 S.W. 2d 1021 (Tex. Sup. Ct. 1934). See 24 Am. Jur. 545 (Gas and Oil § 39).

and oil, with all appurtenant rights, including the rights to drill and produce the gas and oil.[2]

These rights are, however, subject to regulations promulgated by the Railroad Commission of Texas.[3] In order to promote the economic development of each field, the Commission establishes the minimum required acreage per well. But to protect persons with mineral interests in small tracts, it is required by state law to permit one well on any tract, however small, if a distinct interest in the tract is owned, prior to the well-spacing rule, by a person who does not have an identical interest in adjoining tracts.[4] In order to achieve a fair allocation between large and small tracts, the Commission also establishes the maximum allowable production per well.[5]

In this case petitioner, American Trading and Production Corporation, was the lessee under gas and oil leases covering the Northwest and Southeast quarters of Section 29 in the Azalea (Strawn) Field, a proven gas and oil field in Midland County, Texas. (R. 2)*

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[2] *Ibid.*

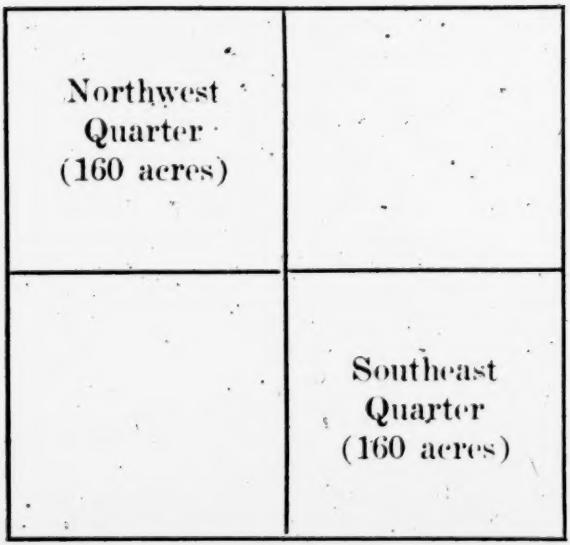
[3] Vernon's Ann. Civ. Stat. Art. 6008, §§ 1-16. Pertinent provisions are printed in Appendix A, *infra*, pp. 1a-5a.

[4] *Railroad Commission of Texas* v. *Humble Oil & Refining Co.*, 151 Tex. 51; 245 S.W. 2d 488 (Tex. Sup. Ct. 1952); *Texas Co.* v. *Railroad Commission of Texas*, 246 S.W. 2d 487 (Tex. Civ. App. 1952).

[5] Vernon's Ann. Civ. Stat. Art. 6008, §§ 12, 13. Appendix A, *infra*, pp. 3a-4a.

* References marked "R" are to the Statement of Facts volume from the District Court, contained in the certified record filed with this Court.

Section 29



American "farmed out" these two tracts to one O'Neill, under an assignment pursuant to which it retained an overriding royalty interest and O'Neill agreed that he would either drill a producing well on each of the two tracts or would forfeit the tract on which such a well was not established to American so that American could drill the well. (R. 3-5) The density of one well for each 160-acre tract complied with the then existing regulations of the Commission.[6] O'Neill drilled a producing well on one tract (the Southeast quarter, not involved here) so that thereafter American had no further rights in that tract other than its overriding royalty. (R. 5) But this did not affect American's rights in the second tract (the

[6] The spacing rule in effect at that time—a statewide rule applicable wherever special rules have not been established for a specific field—permitted a well on each 20 acres.

Northwest quarter), which is in issue in this case. With respect to that tract it was entitled either to have O'Neill drill a well thereon or to drill one itself if O'Neill failed to do so. This was a property right of great value.

In this situation the Commission adopted Special Field Rules for the field in which the Northwest quarter was located.[7] These rules changed the pre-existing spacing requirements by providing for a density of one well for each 640 acres. By their own terms the new rules could not be applied to confiscate or impair any pre-existing interests in tracts less than 640 acres. The rules specifically stated that "in order . . . to prevent confiscation of property" the Commission "will" grant permits for drilling on tracts smaller than the 640-acre size prescribed. This provision was in accordance with decisions of the state courts requiring the Commission to permit a well to be drilled on any tract, regardless of size, if at the time the spacing rule takes effect there is not a complete identity of interest between the owners of that tract and any adjoining tract.[8]

After the rules were promulgated the time allowed O'Neill to drill a well on the second tract expired and thus by operation of law petitioner came into possession of the full leasehold interest in the tract. All the rights of the assignee in this tract under the "farm-out" assignment terminated and all such rights, in-

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[7] Appendix A, *infra*, p. 5a.

[8] See *Railroad Commission of Texas* v. *Humble Oil & Refining Co.*, 151 Tex. 51, 245 S.W. 2d 488 (Tex. Sup. Ct. 1952); *Texas Co.* v. *Railroad Commission of Texas*, 246 S.W. 2d 487 (Tex. Civ. App. 1952).

cluding the right to drill for and possess the minerals, were held by American. On request of American, O'Neill subsequently executed a formal reassignment document (R. 5) so that American could maintain a clear title of record.[9]

American then applied to the Commission for a permit to drill on the Northwest quarter so as to avoid confiscation of this tract. (R. 6) American set forth in its application the fact that, when the new spacing rule was adopted, the tract for which the drilling permit was sought existed as a separate tract, and at the hearing the instruments establishing petitioner's distinctive rights in the Northwest quarter were put into evidence.

The Commission refused to grant petitioner a drilling permit. (R. 6; Appendix C, *infra*, p. 28a.) It held, in effect, that only the temporary rights of the operator, entitled to drill at the time the field rules

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[9] The time schedule of the important events was as follows:

1. Assignment by American to O'Neill	March 21, 1957
2. O'Neill completed well on Southeast quarter of Section 29	August 9, 1957
3. New Field Rules took effect (actually established December 19, 1957)	November 21, 1957
4. Expiration of time allotted to O'Neill for drilling new well	January 7, 1958 [Note]
5. Formal reassignment of undrilled Northwest quarter to American by O'Neill	January 22, 1958

[Note: This period had been extended one month by agreement. Otherwise it would have ended December 7, 1957. This fact is not important, however, since the new field rules took effect on November 21, 1957.]

took effect, need be preserved or considered. In its decision the Commission made no mention of the pre-existing rights reserved by the petitioner in its farm-out assignment. The stated reasons for its decision were that there was an identity of interest throughout both tracts when the field rules took effect, that American reacquired its interest in the Northwest quarter after the new rules, and that therefore to permit American to drill would circumvent the field rules.[10] The Commission assumed that American's rights arose solely from the formal reassignment by O'Neill. But, as acknowledged by the Court of Civil Appeals,[11] it is clear under state law that petitioner regained the possessory estate not by the reassignment but by virtue of its retained interest, which predated the field rules.

This decision by the Commission left the petitioner with a bare legal interest in this tract of land without any right to utilize it by drilling for and producing gas and oil. The Commission decision did not, however, require a reduction in the amount of production, or the rate of production, from the Azalea (Strawn) Field. Under the Texas regulatory system the total monthly allowable production from the field simply continued to be apportioned among the other well owners in the field.[12]

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[10] The Commission cited a general rule that small tracts subdivided subsequent to a spacing rule will not be considered as requiring a well in order to avoid confiscation. (The rule is printed in Appendix A, p. 6a, *infra*.)

The petitioner had advanced the danger of "waste" as an alternative reason for granting the permit, but the decision of the Commission on that issue, also adverse to petitioner, is not at issue in this case.

[11] 323 S.W. 2d 479, 480; Appendix C, *infra*, pp. 18a, 20a.

[12] Vernon's Ann. Civ. Stat. Art. 6008, § 12. See 1A Summers on Oil and Gas 89, 90.

American then petitioned the District Court for the 53rd Judicial District of Texas to set aside the Commission's order. It asserted that the Northwest quarter was entitled to a well, under the above-cited authorities,[13] in order to permit the owner a fair chance to share in the recovery of minerals from the common reservoir under his land. Phillips Petroleum Company, O'Neill, and Baxter, all respondents herein, intervened as defendants in the District Court because of their interest in the mineral rights on neighboring tracts. The District Court found that the facts alleged by American were true—namely, that the Northwest quarter was in existence as a separate tract at the time of the adoption of the new field rules by reason of American's retained interest therein. Accordingly, on September 24, 1958, it entered judgment for American enjoining the Railroad Commission from further refusing to permit American to drill and produce its well. (Appendix C, *infra* p. 26a.) The Railroad Commission then issued a drilling permit, and American proceeded to drill a well on the Northwest quarter from which it secured valuable commercial production of gas and oil.

The Commission and the intervening operators of wells on adjoining tracts (including O'Neill) appealed to the Court of Civil Appeals for the Third Supreme Judicial District of Texas. The Court of Civil Appeals reversed the decision of the District Court on April 1, 1959. (Appendix C, pp. 11a-25a *infra*). The reason stated by the Court for its decision was that:

> "It is our opinion that O'Neill was vested with the title to the leasehold interests covering the SE 4

[13] Note 8, *supra*.

of Section 29 and the NW 4 of Section 29 when, on January 22, 1958, he conveyed by way of reassignment the leasehold interest covering the NW 4 of Section 29 to American. This assignment constituted an illegal subdivision under the density rule then applicable to the area in which the land was located."[14]

By saying that "O'Neill was vested with the title to the leasehold interest" the Court did not mean that American did not also have a property interest in the Northwest quarter. Elsewhere in the opinion the Court stated that "O'Neill was vested with a title which was subject to forfeiture upon condition." (323 S.W. 2d at 480; Appendix C, p. 20a, *infra*). The Court ignored American's interest, however, and entered a ruling which destroys the property interests of American and the other owners of the tract by permitting adjoining operators, including the intervenors, to produce the gas and oil which belongs to American and the other owners.

American filed a motion for rehearing (Appendix B, *infra*, p. 7a), in which it asserted specifically that the denial of a permit to drill constituted a taking of American's pre-existing property rights in violation of the due process and equal protection provisions of the Federal Constitution.[15] The motion for rehearing was denied.

[14] 323 S.W. 2d at 479; Appendix C, p. 17a, *infra*. American had also advanced an independent ground to sustain the decision of the District Court which was decided adversely to it by the Court of Civil Appeals. This alternative ground is not an issue in this case.

[15] This assertion of the constitutional questions was timely under state law. See 3B Tex. Jur. 261, Appeal and Error § 859 (Now 4 Tex. Jur. 2d 234, § 740); *Sid Westheimer Co.* v. *Piner*, 263 S.W. 578.

On May 22, 1959, American applied to the Supreme Court of Texas for a writ of error (Appendix B, *infra*, p. 9a). The application also asserted specifically that denial of the permit constituted a confiscation of petitioner's property in violation of the due process and equal protection clauses of the Federal Constitution. The application was refused on June 17, 1959. American filed a motion for rehearing on June 30, 1959, again specifically asserting violation of the Federal Constitution's due process and equal protection clauses. This was denied on July 29, 1959.

REASONS FOR GRANTING THE WRIT

The Court of Civil Appeals has made a decision substantially impairing the rights of owners of small tracts in undeveloped fields who lease or "farm out" their tracts to have them drilled and developed. The effect of the decision is that small farmers or ranchers as well as others who enter into "farm-out" agreements with established operators may find, when the field is "proven", that their right to share in the bounty of their gas and oil is substantially forfeited and destroyed and that their gas and oil is being drained off by others. This important decision was made without adequate or indeed any consideration of its damaging effect on large numbers of property owners and without discussion of the constitutional questions involved. It is clearly not in accord with the applicable decisions of this Court.

1. Importance of the Question

This case involves retained property interests in gas and oil which play and have historically played a vital role in gas and oil transactions. Such interests are presently held by many persons who have placed

reliance thereon in the belief that they are as fully protected against confiscation as are other real property interests. The effect of the state court's decision is to deprive these interests of very fundamental protections, thereby upsetting the heavy reliance placed on them, impairing their utility in future transactions, and depriving many landowners and lessees of the means to secure development and protection of their gas and oil property rights. The decision removes these retained property interests from the constitutional protection against confiscation and denies them equal protection with other mineral property rights.[16]

a. Why the interests are created. The owner of a mineral fee very frequently finds it necessary or expedient to arrange for another person to conduct exploration and drilling on the owner's estate. The owner—often a farmer, rancher or other person with no experience in mineral development—may find he does not have the necessary expert knowledge or risk capital to attempt drilling on his own land. Thus, ordinarily he executes a mineral lease. Such leases, under Texas law, pass to the lessee a qualified fee interest in the minerals, leaving the original owner with a reversionary right which will return the fee to him on the lessee's failure to develop the minerals in a proper and timely fashion.

In turn, the lessee may "farm out" portions of the mineral estate because he cannot or does not wish to take the risks involved in drilling in the portions he assigns. This is a sublease. The sublessor commonly retains an interest which insures that the fee will return to him in case the sublessee does not develop the

[16] A discussion of the conflict between the lower court's decision and applicable decisions of this Court appears in section 2, *infra*.

property in a proper and timely fashion. This protects not only his interest in the gas and oil but also that of the original owner.

The interest retained by the original owner who leases minerals is the same as that retained by the lessee who subleases under a "farm-out" assignment. It has universally been held in Texas to be a real property interest.[17]

b. Importance of the interests. These retained interests are of extreme importance to persons attempting by lease or "farm out" to secure development of their oil properties, because they constitute the sole security against a most dreaded possibility—failure of the lessee (or sublessee) to develop mineral reosurces which are being developed by neighboring owners.[17a]

An original owner of rights in a reservoir of minerals wishes to have it developed at least as fast as his neighbors, so that he will not find a good part of the reservoir drained when he finally drills his well and begins to share in the allocated withdrawals from the reservoir. His retained interest protects him against undue delay by his lessee.

Similarly, the lessee who "farms out" a portion of his mineral estate wishes to secure development thereon before significant drainage occurs. And, in addition, he must assure himself of development in due time or he may find that all of his interest is forfeited to the original lessor by virtue of the lessor's retained

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[17] *E.g. Sheffield* v. *Hogg*, 124 Tex. 290, 77 S.W. 2d 1021 (Tex. Sup. Ct. 1934); *James* v. *Dalhart*, 254 S.W. 2d 826 (Tex. Civ. App. 1952); *Walts* v. *City of Houston*, 196 S.W. 2d 553 (Tex. Civ. App. 1946); *Caruthers* v. *Leonard*, 254 S.W. 779 (Tex. Com. App. 1923); *Perry* v. *Smith*, 231 S.W. 340 (Tex. Com. App. 1921). See 24 Am. Jur. 545 (Gas and Oil, § 39).

[17a] See 2 Summers on Oil and Gas 317 (§ 303)

right. The lessee's retained interest in the "farmed out" properties is designed to protect him against this double peril.

c. Widespread use of the interests. Leases and "farm-outs" (subleases) are transactions essential to the economic development of gas and oil resources, in that they permit the ready transfer of mineral estates to parties capable of and interested in developing them. And the retained interests created in these transactions constitute the basic insurance that the purpose of the transactions will be carried out. Essentially, the retained interest represents a right reserved by a transferor of mineral property to secure timely development of his property by one means or another. It gives him the right to drill in case his transferee defaults.

For these important commercial reasons, a retained interest is found in virtually every mineral lease and in a great proportion of mineral subleases or "farm-outs".

d. Impact of the court's ruling. The ruling of the Court of Civil Appeals in the present case cuts a broad hole in these important and widely held property rights. It deprives the owners of such rights of all protection against serious dangers from which the owners were previously secure.

In determining whether American had an interest in the Northwest quarter prior to the new field rules, the Court ignored American's carefully retained property interest. It paid attention to O'Neill's rights, acquired in the "farm-out" assignment from American, but neglected entirely American's interest, which

had been reserved in the same assignment. The evident effect of the Court's decision is to distinguish between the operator's mineral interest and the petitioner's retained interest, treating the latter as though it were not to be considered a property interest at all.

This neglect of the retained interest means, most immediately, that these rights are not entitled to protection against subsequently established spacing rules. Thus the precise deprivation presented by this case can recur whenever new field rules take effect after execution of a lease or farm-out assignment. The party having an obligation to drill, on peril of forfeiting his interest, can drill on one portion and refrain from developing the remaining sectors on which he has an obligation to drill. Those sectors will revert to the holder of the retained interest, but he—just like petitioner in the present case—will be barred from drilling thereon. Meanwhile the assignee, though no longer having the obligation to drill, will be able to withdraw, through his well, the minerals lying under the reverted land. It is interesting to note that this is precisely the position of the assignee, O'Neill, in this case, and that he intervened in the proceedings below to aid in securing this advantage to himself.

More fundamentally, the principle of this case can lead to other serious losses to the holders of retained interests. There is no reason whatever to expect, under the state court's decision, that interests of this sort will not be considered—in other contexts as well as the present one—as something less than interests in real property. For example, holders of such interests can find themselves not entitled to participate in proceedings before the Railroad Commission or to appeal to

the courts with respect to regulatory orders affecting the lands in which the hold an interest. Thus the holders of retained interests will be deprived of procedural and substantive rights to which holders of real property rights are entitled.

The Court of Civil Appeals ignored the fact that the relationship between American and O'Neill was governed by American's retained property right. It treated the parties as though they were simply two parties to a contract who had agreed to develop certain lands on a 160-acre basis. By doing this, it makes their interests more readily subject to alteration by regulatory action, but in the process it transforms and drastically impairs the property right which had in fact been established prior to the spacing rule and was retained and in existence when the spacing rule was imposed. It thus demotes literally thousands of carefully established retained interests—*always previously considered interests in land under state law*—to the status of mere contractual rights subject to defeasance in many ways previously considered impossible.

Whether or not the court's revolutionary decision was correct as a matter of state law is not of course a matter of concern here. The above facts clearly demonstrate, however, the importance of determining whether the decision can stand under the Federal Constitution.[18]

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[18] "The protection of private property in the 5th Amendment presupposes that it is wanted for public use, but provides that it shall not be taken for such use without compensation. A similar assumption is made in the decisions upon the 14th Amendment. Hairston v. Danville & W.R. Co., 208 U.S. 598, 605. When this seemingly absolute protection is found to be qualified by the police

2. Conflict With Applicable Decisions of This Court

a. Due process. Under the circumstances described above, the Commission's action in refusing American a permit to drill on the 160-acre tract in which it held a valuable interest prior to and at the time of the spacing rule constitutes a taking of American's property without compensation, in violation of the Due Process clause of the Fourteenth Amendment. The decision of the Court of Civil Appeals upholding the Commission represents a complete (if perhaps unwitting) repudiation of the leading decisions of this Court in *Pennsylvania Coal Co.* v. *Mahon*, 260 U.S. 393 (1922) and *Thompson* v. *Consolidated Gas Utilities Corp.*, 300 U.S. 55 (1937). It is also contrary to other decisions of this Court dealing with the taking of private property by sovereign regulatory authority.

Petitioner does not, of course, contend that the State of Texas lacks authority to regulate mineral development, in the interest of conservation and protection of the correlative rights of all landowners. See *Cities Service Gas Co.* v. *Peerless Oil and Gas Co.*, 340 U.S. 179 (1950); *Champlin Refining Co.* v. *Corporation Commission*, 286 U.S. 210 (1932); *Ohio Oil Co.* v. *Indiana*, 177 U.S. 190 (1900). Nor does petitioner raise any question as to the validity of the Commission well-spacing regulation. See *Railroad Commission* v. *Rowan & Nichols Oil Co.*, 310 U.S. 573 (1940), 311 U.S. 570 (1941).

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power, the natural tendency of human nature is to extend the qualification more and more until at last private property disappears. But that cannot be accomplished in this way under the Constitution of the United States." Holmes, J. in *Pennsylvania Coal Co.* v. *Mahon*, 260 U.S. 393, 415 (1922).

Petitioner challenges only the Commission's particular application of its well-spacing rules so as effectively to deprive petitioner of its entire retained property right in the tract here in question. The Commission's action transcends the minimal constitutional limits on state regulatory schemes of this sort.

First, the Commission's action does not simply *restrict* petitioner's enjoyment of its mineral estate; instead it deprives petitioner of its entire mineral estate by precluding petitioner from all production while other well owners proceed to drain the reservoir.

In this respect the action of the Commission clearly conflicts with the decision of this Court in *Pennsylvania Coal Co.* v. *Mahon*, 260 U.S. 393 (1922), a decision which constitutes the cornerstone for much of the modern law on the powers of governmental regulatory authority to impair property interests without compensation. In that case, the coal company conveyed surface rights in a tract it owned, retaining the mineral rights. Later the State enacted a statute prohibiting the removal of coal in such a way as to cause subsidence of inhabited dwellings. In a suit by the grantee of the surface rights, who inhabited a house thereon, the state court enjoined the coal company from removing coal underneath the house. Thus, though the statute was on its face a simple regulatory enactment, it was applied in a way which clearly destroyed mineral property rights predating the statute. This Court held such an application of the statute to be a violation of the due process clause. Speaking through Justice Holmes, it said:

> "As long recognized, some values are enjoyed under an implied limitation, and must yield to the police power. But obviously the implied limita-

tion must have its limits or the contract and due process clauses are gone. One fact for consideration in determining such limits is the extent of the diminution. When it reaches a certain magnitude, in most if not all cases there must be an exercise of eminent domain and compensation to sustain the act.

* * *

"It is our opinion that the act cannot be sustained as an exercise of the police power, so far as it affects the mining of coal under streets or cities in places where the right to mine such coal has been reserved. As said in a Pennsylvania case, 'For practical purposes, the right to coal consists in the right to mine it.'

* * *

"The general rule, at least, is that while property may be regulated to a certain extent, if regulation goes too far it will be recognized as a taking." 260 U.S. at pp. 413-15.

The early cases approving the authority of the States to regulate production of gas and oil set forth similar ultimate limits on the authority of the States. Thus in *Ohio Oil Company* v. *Indiana*, 177 U.S. 190 (1900), the Court noted:

"As to gas and oil the surface proprietors within the gas field all have the right to reduce to possession the gas and oil beneath. They could not be absolutely deprived of this right without the taking of private property. But there is a co-equal right in them all to take from a common source of supply the two substances which in the nature of things are united, though separate." 177 U.S. at pp. 209-10.

The principle of the *Pennsylvania Coal* case has continued to guide the Court through many years. Thus

in the recent decision in *United States* v. *Central Eureka Mining Co.*, 357 U.S. 155 (1958), the Court said at p. 168:

> "[In passing on questions of 'taking'] we have recognized that action in the form of regulation can so diminish the value of property as to constitute a taking. *United States* v. *Kansas City Life Ins. Co.*, 339 U.S. 799, 70 S. Ct. 885; *United States* v. *Causby*, 328 U.S. 256 . . ."

As in the *Pennsylvania Coal* case, the present action of the Texas Commission deprives petitioner of *all* of its carefully reserved rights to the minerals in the Northwest quarter. It did not simply *limit* petitioner's enjoyment of its mineral rights.

In fact, the present case is even more objectionable than the *Pennsylvania Coal* case. It was possible in that case—as pointed out by Mr. Justice Brandeis in his dissenting opinion—to view the state's actions as (a) simply a limitation of sub-surface rights for the benefit of more socially important surface rights on the same property, and (b) a temporary limitation rather than a permanent one. No such charitable views of the state's action in the present case are possible.[19]

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[19] Mr. Justice Brandeis asserted that the subsurface owner should not gain greater rights simply because his interest has been severed from the surface rights. Moreover, Brandeis attached importance to the fact that the subsurface owner might eventually have an opportunity to remove the coal when the use of the surface for a habitation was abandoned. In the case at bar, the development of subsurface minerals is not inconsistent with surface uses and is clearly the most important utilization of the land here in question. Elimination of the right to drill amounts to a deprivation of the large part of the value. Moreover—and most important—the deprivation of a *present* right to remove the gas and oil unques-

Second, the Commission's action in absolutely depriving petitioner of all opportunity to enjoy its mineral rights serves no regulatory purpose whatever.[20]

a. It does not prevent waste, inasmuch as it does not require a reduction in the total amount of gas and oil withdrawn from the field or even a reduction in the *rate* of withdrawal. Under the Texas system of regulation, the Commission determines monthly the total amount of minerals which may be withdrawn from a given field. It then apportions this amount among whatever wells are operating in the field at that time.[21] Thus the closing of one well does not require a reduction in the output. The closed well's allowable monthly production may simply be allocated among remaining wells.

b. Nor can it be justified as a means for protecting neighboring owners of gas and oil from disproportionate withdrawals from the common reservoir by petitioner. The Commisson has authority to reduce the amount of gas and oil taken from a small tract in order to prevent the holder thereof from removing an unfair

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tionably constitutes a *permanent* deprivation of the minerals, because neighboring well owners can continue to drain the gas and oil from underneath petitioner's tract. Thus, unlike the case where coal was concerned, it is not possible to look at this deprivation as one which might turn out to be only temporary.

[20] The Commission's statutory charter provides that it shall "prorate and regulate . . . production for the protection of public and private interests: (a) In the prevention of waste as 'waste' is defined herein; (b) In the adjustment of correlative rights and opportunities of each owner of gas in a common reservoir to produce and use or sell such gas as permitted in this Article." See Vernon's Ann. Civ. Stat., Art. 6008, § 10, printed in Appendix A at p. 2a, *infra*.

[21] Vernon's Ann. Civ. Stat., Art. 6008, § 12, printed in Appendix A, *infra*, p. 3a. See 1A Summers on Oil and Gas § 97.

portion of the underlying minerals. It is required to apportion the monthly production of the field among the wells in the field according (among other factors) to the extent of the mineral acreage owned by the various producers.[22] Such an alternative being available to the Commission, there is not even a color of regulatory justification for its refusal to permit petitioner any production whatever.

The lower court's decision conflicts in this respect with the decision of this Court in *Thompson* v. *Consolidated Gas Utilities Corp.*, 300 U.S. 55 (1937). In that case it was clear from the record, as it is here, that the contested order of the Railroad Commission of Texas could not serve either to prevent waste or to protect the correlative rights of the various owners of minerals in the common reservoir. This court unanimously held the order a violation of the Due Process Clause. The Court's opinion, by Mr. Justice Brandeis, stated that "our law reports present no more clear instance of the taking of one man's property and giving it to another."[23]

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[22] Vernon's Ann. Civ. Stat., Art. 6008, § 13, printed in Appendix A at p. 4a, *infra*. 1A Summers on Oil and Gas 90 (§ 97).

[23] 300 U.S. at pp. 79-80. The *Thompson* case concerned these facts: As a conservation measure, owners of gas wells were prohibited from producing if they had no market for the gas removed. All well owners had equal opportunity to find a market and thereby to produce. The complaining party had found a market and constructed pipeline facilities to transport his gas to it. Production from his wells of the quantities needed to serve his market could not cause drainage from the land of others. Yet he was required to purchase gas on a pro-rata basis from other well owners who had not found a market. He was thus required to share his expensively acquired market and transportation facilities with others who had an equal opportunity to market and produce but had not done so. The Commission's order served no purpose whatever in preventing waste or preventing disproportionate withdrawals by one mineral owner.

In both the *Pennsylvania Coal* and *Thompson* cases the state action held to be invalid operated to the particular advantage of other private property owners—to the precise extent it impaired the property of the complaining party. Thus in the *Pennsylvania Coal* case the surface owner was in effect given a valuable subsurface right for which he had not paid, and in the *Thompson* case the other well owners were given a portion of Consolidated's market and pipeline. In the present case, the other private owners of mineral interests in the Azalea (Strawn) reservoir are similarly greatly benefited at petitioner's expense. The state's action, depriving petitioner of all opportunity to remove gas and oil, simply gives them extra production exactly equal to the amount petitioner would withdraw if its well were open.[24]

This Court has not attempted to formulate general rules distinguishing cases of "taking" from cases of "regulation." In *United States* v. *Central Eureka Mining Co.*, 357 U.S. 155 (1958), it stated:

> "Traditionally, we have treated the issue as to whether a particular governmental restriction amounted to a constitutional taking as being a question properly turning upon the particular circumstances of each case. See *Pennsylvania Coal Co.* v. *Mahon* . . ." (357 U.S. at 168)

There is not the least difficulty, however, in finding that the present case falls within the category of those

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[24] In *International Paper Co.* v. *United States*, 282 U.S. 399 (1931), this Court was faced with a similar situation. International, owner of certain water rights, had seen them taken away by a wartime government order which permitted another private party to use them. Even though there was considerably greater public necessity for the order than in the present case, the Court held this a taking which required compensation under the Fifth Amendment.

in which an unlawful taking was found to have occurred. The diminution of the value of petitioner's property here is complete and not just partial. Moreover, in contrast to numerous cases in which an unlawful taking was held not to exist, there is no suggestion that the taking herein is necessary or appropriate for a public purpose. *See Miller* v. *Schoene*, 276 U.S. 272 (1928); *Block* v. *Hirsch*, 256 U.S. 135 (1921); *United States* v. *Central Eureka Mining Co.*, 357 U.S. 155 (1958). If American had possessed the present right to drill a well on the tract at the time the new Field Rules were adopted, there would have been no contention that "conservation" required destruction of this right. The only difference in this case is that at the moment the Field Rules were adopted the drilling right was conditionally entrusted to another, subject to an eventuality which quickly happened, namely, a revesting of this right in American a few weeks after the new Field Rules were adopted. There is no claim and there can be no claim that the state's conservation program requires or justifies a destruction of American's right in these circumstances. Finally, the State's action had the effect of transferring to other private parties the valuable property taken away from petitioner. There can be no question that the decision of the Texas Court of Civil Appeals, rendered without any consideration of the due process problem, is contrary to the *Pennsylvania Coal* and *Thompson* cases and to the principles established in the numerous other decisions of this Court concerned with takings of private property.

b. Equal protection. The Commission's action also offends the equal protection clause of the Fourteenth Amendment in two different respects, described below. Thus, even if the due process limits discussed above

were not applicable in this case, the Commission's action would be invalid because it did not afford American the protection which the Commission affords others in substantially the same position.

(1) The Commission applied its own rules to American in a manner which arbitrarily denied American the protection which was afforded other property owners both by the terms of the rules and by the Commission's normal applications thereof. The rules speak in terms of protecting the interests of *all* property owners who held their property prior to the adoption of the new well-spacing requirements in an area.[25] The rules make no distinction between owners of retained rights of the sort possessed by petitioner, on the one hand, and owner of other kinds of property rights, on the other hand.

The established practice of the Commission is to permit the drilling of a well on a tract containing less than the prescribed acreage in any case where the failure to grant such a permit would cause the owner of even the smallest fraction of the gas and oil in a tract to be deprived of equal opportunity with adjoining mineral owners to recover the gas and oil beneath the tract. Our research discloses that this practice of the Commission has been the subject of reported litigation in only two cases.[26] In both, the

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[25] Rule 1 of the new Field Rules for the Azalea (Strawn) field provides that "the Commission will, in order . . . to prevent the confiscation of property, grant exceptions to permit drilling within shorter distances than herein prescribed. . . ." (Appendix A, p. 5a, *infra*.)

[26] *Railroad Commission of Texas* v. *Humble Oil & Refining Co.*, 151 Tex. 51, 245 S.W. 2d 488 (Tex. Sup. Ct. 1952); *Texas Co.* v. *Railroad Commission of Texas*, 246 S.W. 2d 487 (Tex. Civ. App. 1952).

Texas courts required the Commission to grant the permits even though there was complete identity of ownership, as to everything except a very small fraction of the royalty interest, between the tract on which the well was sought to be drilled and an adjoining tract on which a well existed.

In view of the wording of the Commission's rules and its standard practice in administering the rules, the refusal to protect American's substantial and important property interest solely because, at the time the new rules took effect, O'Neill rather than American had the *present* right to drill, constitutes a denial of equal protection. See *Smith* v. *Cahoon*, 283 U.S. 553 (1931); *Cumberland Coal Co.* v. *Board of Revision*, 284 U.S. 23 (1931); *Morey* v. *Doud*, 354 U.S. 457 (1957).

(2) Even if the rules contained an explicit distinction between holders of retained property interests such as petitioner's, on the one hand, and holders of other types of interests on the other, such a distinction would be insupportable as a constitutional matter. There is no reasonable basis for thus differentiating between owners of substantial mineral interests.[27]

THE ALTERNATIVE DISPOSITION

Petitioner suggests that an appropriate form of relief in this case, as an alternative to reviewing the decision of the State Court on the merits, may be the issuance of a writ of certiorari followed by a remand to the lower court for reconsideration of the constitutional questions in this case, and, in its discretion,

[27] See cases cited in the preceding paragraph.

of the questions of state law in the light of the constitutional problems presented.[28]

It is not clear that the court below meant to rule that a retained property interest in gas and oil, created before the Field Rules, need not be protected. On the one hand its opinion acknowledges that the petitioner had a property interest in the minerals on the tract involved prior to the Field Rules.[29] The opinion renders that interest worthless in spite of its priority. The decision therefore will no doubt stand in Texas as authority for the proposition that these important retained property rights are not protected against the confiscatory application of a subsequent field order, even though other interests are thus protected. On the other hand the opinion of the court below indicates that it did not adequately consider the resulting conflict between its holding and the applicable decisions of this Court.

It is uncertain, therefore, that if the lower court should again have an opportunity to consider the constitutional issues, it would persist in the proposition

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[28] A further alternative disposition would be to grant certiorari and then allow a continuance to enable petitioner itself to apply to the State Court for such reconsideration. See *Loftus* v. *Illinois*, 334 U.S. 804, 805 (1948); *Herb* v. *Pitcairn*, 324 U.S. 117 (1945).

[29] The Court said "We construe the farm-out agreement as vesting in O'Neill title to the leasehold estates assigned to him on completion of the first well subject to divestment upon non-performance of the stated conditions (323 S.W. 2d at 479; Appendix C, *infra*, p. 18a). It also said "This is a practical construction of the agreement by the parties and clearly connotes that O'Neill was vested with a title which was subject to forfeiture upon condition." (323 S.W. 2d at 480; Appendix C, *infra*, p. 20a.)

for which its decision stands, namely, that a retained property interest created before the field order may be confiscated by the new spacing rules. It is difficult for us to believe that the state courts, if required to reconsider the constitutional implications, would not protect such widely used and important interests when they preexist new field rules. There is a substantial possibility that the constitutional question now present in the case would be eliminated by a remand and a further decision.

This Court has previously remanded cases raising a federal constitutional question when it appeared that the state courts might have dealt differently with questions of state law if they had given proper consideration to the constitutional question present. See *Williams* v. *Georgia*, 349 U.S. 375 (1955); *Patterson* v. *Alabama*, 294 U.S. 600, (1935).[30]

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari to the Court of Civil Appeals for the Third Supreme Judicial District of Texas should be granted and the case either reviewed by this Court or

[30] Cf. also *Minnesota* v. *National Tea Co.*, 309 U.S. 551 (1940); *Naim* v. *Naim*, 350 U.S. 891 (1955); *Loftus* v. *Illinois*, 334 U.S. 804, 805 (1948); *Herb* v. *Pitcairn*, 324 U.S. 117 (1945).

remanded to the Court of Civil Appeals for consideration of the constitutional questions present in the case.

Respectfully submitted,

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September 9, 1959

APPENDIX A

CONSTITUTIONAL PROVISION, STATUTE, AND REGULATIONS CITED AND QUOTED

Constitution of the United States

AMENDMENT 14

"Section 1. * * * nor shall any State deprive any person of life, liberty, or property, without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws."

Vernon's Annotated Civil Statutes

Art. 6008. 7849. PRODUCTION AND USE OF NATURAL GAS

Declaration of policy

Sec. 1. In recognition of past, present, and imminent evils occurring in the production and use of natural gas, as a result of waste in the production and use thereof in the absence of correlative opportunities of owners of gas in a common reservoir to produce and use the same, this law is enacted for the protection of public and private interests against such evils by prohibiting waste and compelling atable production.

Commission to make and enforce rules and regulations

Sec. 6. The Commission shall make and enforce rules, regulations, or orders for the conservation of natural gas, to prevent the waste thereof, and otherwise to accomplish the purpose of this Article, including rules, regulations, or orders for the following purposes:

(1) to prevent the waste, as hereinbefore defined, of natural gas in drilling and producing operations and in the piping and distribution thereof.

(2) to require dry or abandoned wells to be plugged in such way as to confine natural gas and water in the strata in which they are found and to prevent them from escaping into other strata.

(3) for the drilling of wells and preserving a record thereof.

(4) to require wells to be drilled and operated in such manner as to prevent injury to adjoining property.

(5) to prevent natural gas and water from escaping from the strata in which they are found into other strata.

(6) to require records to be kept and reports made.

(7) to provide for the issuance of permits, and other evidences of permission when the issuance of such permits, or permission is necessary or incident to the enforcement of it blanket grant of authority to make rules necessary to effectuate the law.

Commission to prorate and regulate daily production

Sec. 10. It shall be the duty of the Commission to prorate and regulate the daily gas well production from each common reservoir in the manner and method herein set forth. The Commission shall prorate and regulate such production for the protection of public and private interests: (a) In the prevention of waste as "waste" is defined herein; (b) In the adjustment of correlative rights and opportunities of each owner of gas in a common reservoir to produce and use or sell such gas as permitted in this Article.

Commission to exercise authority, when

Sec. 11. The Commission shall exercise the authority to accomplish the purpose designated under item (a) of Sec. 10 when the presence or imminence of waste is supported by a finding based upon the evidence introduced at a hearing to be held as herein provided.

The Commission shall exercise the authority to accomplish the purpose designated under item (b) of Sec. 10 when evidence introduced at a hearing to be held as herein provided will support a finding made by the Commission that the aggregate lawful volume of the open flow or daily

potential capacity to produce of all gas wells located in a common reservoir, is in excess of the daily reasonable market demand for gas from gas wells that may be produced from such common reservoir, to be utilized as permitted in this Article.

Determination of status of gas production; proration and regulation

Sec. 12. It shall be the duty of the Commission to determine the status of gas production from all reservoirs in this state. If and when the Commission finds that waste exists or is imminent in the production of gas from any reservoir, or that the capacity of the wells to produce gas from any reservoir exceeds the market demand for gas from such reservoir, the Commission shall then proceed by proper order to prorate and regulate the gas production from such reservoir on a reasonable basis. On or before the 20th day of each month, the Commission, after notice and hearing, shall determine (1) the lawful market demand for gas to be produced from each such reservoir during the following month; and (2) the volume of gas that can be produced from such reservoir and each well therein during the following month, without waste. The Commission shall then fix the monthly reservoir allowable of gas to be produced from such reservoir at the lawful market demand therefor or at the volume that can be produced from such reservoir without waste, whichever is the smaller quantity. The monthly reservoir allowable shall be allocated among all wells entitled to produce gas therefrom so as to give each well its fair share of the gas to be produced from the reservoir, provided that each well shall be restricted to the amount of gas that can be produced from it without waste. The volume of gas so allocated to each well shall be regarded as the monthly allowable for such well. The daily market demand for gas, and the daily allowable, shall be determined by dividing the monthly demand and the monthly allowable by the number of days in the month.

Factors in determining daily allowable production

Sec. 13. In determining the daily allowable production for each gas well the Commission shall take into account the size of the tract segregated with respect to surface position and common ownership upon which such gas well or wells are located; the relation between the daily producing capacity of each gas well and the aggregate daily capacity of all gas wells producing the same kind of gas in the same common reservoir or zone; and all other factors which are pertinent; provided that the Commission shall not take into account the size of the tract upon which any gas well or wells are located in excess of the efficient drainage area of such well or wells, producing at twenty-five (25%) per cent of the daily productive capacity, which drainage area shall be determined by the Commission. In ascertaining the drainage area of a well, the Commission shall take into account such factors as are reflected in the productive capacity of a gas well, including formation pressure, the permeability and porosity of the producing formation, and the well bore's structural position, together with all other factors taken into account by a reasonably prudent operator in determining the drainage area for a gas well.

Production and sale of gas from common reservoir where demand is seasonal

Sec. 14. In order to adjust the correlative rights and opportunities of each owner to produce, use, and sell gas from a common reservoir from which a portion of the market demand is seasonal or where a portion thereof fluctuates from month to month, the Commission may permit the wells in such reservoir to be produced in excess of the monthly allowable if no waste is occasioned thereby, provided (1) no well shall in any one month be permitted to produce in excess of twice its monthly allowable or to produce at a rate in excess of twenty-five (25%) per cent of the daily producing capacity of such well as found by the Commission; that (2) any well that has produced twice its

allowable for six successive months shall be closed in until its production and allowable are in balance, and that (3) the Commission shall, on the 1st day of March and September of each year, restrict production from all wells that are then overproduced to such fractional part of their monthly allowable as will bring the accumulated allowables and the accumulated monthly production in balance during the next six months. In like manner the Commission may by appropriate order permit any gas well to be underproduced for a period of six consecutive months and may allow the accumulated underproduction to be produced in addition to the regular monthly allowable during the following six months period.

Production in violation of valid orders

Sec. 16. It shall be unlawful for any person to produce gas from a gas well in violation of the valid orders of the Railroad Commission of Texas.

Texas Railroad Commission Regulations

Special Order No. 8-36,924. Adopting Rules for the Azalea (Strawn) Field, Midland County, Texas, Effective November 21, 1957.

"RULE 1. No gas well shall hereafter be drilled nearer than two thousand six hundred forty (2640) feet to any well completed in or drilling to the same reservoir on the same lease, unitized tract or farm, and no well shall be drilled nearer than six hundred sixty (660) feet to any property line, lease line or subdivision line; provided, however, that the Commission will, in order to prevent waste or to prevent the confiscation of property, grant exceptions to permit drilling within shorter distances than herein prescribed whenever the Commission shall have determined that such exceptions are necessary either to prevent waste or to prevent the

confiscation of property. When exception to this rule is desired, application therefor shall be filed and will be acted upon in accordance with the provisions of Commission Statewide Rules 37 and 38, which applicable provisions of said rules are incorporated herein by reference.

"The aforementioned distances in the above rule are minimum distances to allow an operator flexibility in locating a well, and the above spacing rule and the other rules to follow are for the purpose of permitting only one well to each six hundred forty (640) acre proration unit.

"In applying this rule the general order of the Commission with relation to the subdivision of property shall be observed."

Special Order dated May 29, 1934, Regarding Application of Rule 37.

"It Is Ordered by the Railroad Commission of Texas, That in applying Rule 37 (Spacing Rule) of Statewide application and in applying every special rule with relation to spacing in every field in this State no subdivision of property made subsequent to the adoption of the original spacing rule will be considered in determining whether or not any property is being confiscated within the terms of such spacing rule, and no subdivision of property will be regarded in applying such spacing rule or in determining the matter of confiscation if such subdivision took place subsequent to the promulgation and adoption of the original spacing rule."

APPENDIX B

No. 10,663

IN THE

COURT OF CIVIL APPEALS

FOR THE THIRD SUPREME JUDICIAL DISTRICT OF TEXAS

AT AUSTIN

RAILROAD COMMISSION OF TEXAS, ET AL., *Appellants*,

v.

AMERICAN TRADING AND PRODUCTION CORPORATION, *Appellee*.

MOTION OF APPELLEE FOR REHEARING

TO SAID HONORABLE COURT OF CIVIL APPEALS:

Appellee, the American Trading and Production Corporation, respectfully moves the Court to reconsider and set aside the opinion and judgment of the Court rendered April 1, 1959, reversing and rendering the trial court judgment herein, to grant appellee a rehearing, and to affirm the trial court judgment, and shows to the Court:

1.

The Court of Civil Appeals erred in failing to hold that the trial court correctly rendered judgment cancelling and enjoining enforcement of the Railroad Commission's order denying appellee a permit to drill a first well on its 160-acre NW 4 of Section 29 as an exception to the Azalea (Strawn) Field 640-acre gas-well density rule, for the reason that the evidence conclusively reflects that the 160-acre NW/4 of Section 29 was lawfully created and existing as a separate 160-acre tract for oil and gas development prior to the adoption of the field rules; and appellee was entitled to drill a first well on said tract as a matter of right, and denial of that right constitutes confiscation of appellee's

property in violation of State and Federal constitutional provisions prohibiting the taking of property without due process of law and guaranteeing the equal protection of the laws.

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4.

The Court of Civil Appeals erred in holding that the Railroad Commission's Special Order No. 8-38390 denying appellee a permit to drill a first well on its 160-acre NW 4 of Section 29 was a valid order in all respects, for the reason that the denial of such permit constitutes confiscation of appellee's property in violation of State and Federal constitutional provisions prohibiting the taking of property without due process of law and guaranteeing the equal protection of the laws.

• • • • •

WHEREFORE, premises considered, appellee prays that this motion be granted, that the opinion and judgment of the Court dated April 1, 1959, be set aside, and that judgment be rendered affirming the trial court judgment herein; and for such other orders and relief to which appellee may be justly entitled.

Appellee is in the process of preparing, and will file within the next few days, an additional written argument in support of this motion and the correctness of the trial court judgment herein; and appellee respectfully requests the indulgence of the Court.

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IN THE

SUPREME COURT OF TEXAS

AMERICAN TRADING AND PRODUCTION CORPORATION, *Petitioner*,

v.

RAILROAD COMMISSION OF TEXAS, ET AL., *Appellants*.

ERROR TO THE COURT OF CIVIL APPEALS FOR THE THIRD SUPREME JUDICIAL DISTRICT OF TEXAS, AT AUSTIN

APPLICATION FOR WRIT OF ERROR

TO THE HONORABLE SUPREME COURT OF TEXAS:

American Trading and Production Corporation applies for the issuance of a Writ of Error to the Court of Civil Appeals for the Third Supreme Judicial District of Texas, at Austin, to review and correct errors of law committed by said Court in its opinion and judgment dated April 1, 1959, in Cause No. 10,663, which reversed and rendered a final judgment of the 98th District Court of Travis County, Texas, setting aside an order of the Railroad Commission denying petitioner's application for permit to drill a first well on its 160-acre drilling unit in Midland County, Texas, and permanently enjoining the Commission from interfering with the drilling of that well and lawful production therefrom.

The respondents are The Railroad Commission of Texas and its Members: Joseph L. O'Neill, Jr.; Murphy H. Baxter; and Phillips Petroleum Company.

* * * * *

Points of Error

First Point

(Par. 1 in Motion for Rehearing)

The Court of Civil Appeals erred in failing to hold that the trial court correctly rendered judgment cancelling and enjoining enforcement of the Railroad Commission's order denying petitioner a permit to drill a first well on its 160-acre NW/4 of Section 29 as an exception to the Azalea (Strawn) Field 640-acre gas-well density rule, for the reason that the evidence conclusively reflects that the 160-acre NW/4 of Section 29 was lawfully created and existing as a separate 160-acre tract for oil and gas development prior to the adoption of the field rules, and petitioner was entitled to drill a first well on said tract as a matter of right; and denial of that right constitutes confiscation of petitioner's property in violation of State and Federal Constitutional provisions prohibiting the taking of property without due process of law and guaranteeing the equal protection of the laws.

* * * * *

Fifth Point

(Par. 4 in Motion for Rehearing)

The Court of Civil Appeals erred in holding that the Railroad Commission's Special Order No. 8-38390 denying petitioner a permit to drill a first well on its 160-acre NW 4 of Section 29 was a valid order in all respects, for the reason that the denial of such permit constitutes confiscation of petitioner's property in violation of State and Federal Constitutional provisions prohibiting the taking of property without due process of law and guaranteeing the equal protection of the laws.

APPENDIX C

Opinion of the Court of Civil Appeals, Third Supreme Judicial District of Texas, at Austin

IN THE COURT OF CIVIL APPEALS, THIRD SUPREME JUDICIAL DISTRICT OF TEXAS, AT AUSTIN

No. 10,663

RAILROAD COMMISSION OF TEXAS ET AL., *Appellants*

v.

AMERICAN TRADING AND PRODUCTION CORPORATION, *Appellee*

FROM DISTRICT COURT OF TRAVIS COUNTY, 53RD JUDICIAL DISTRICT, NO. 111,501, HONORABLE CHAS. O. BETTS, JUDGE.

Appellee American Trading and Production Corporation, hereinafter called American, sued the Railroad Commission of Texas and its members, in the nature of a statutory appeal, to vacate an order of the Commission denying American's application for a permit to drill a well on a 160-acre tract, being the NW 4 of Section 29, Blk. 38, Township 2 South, T. & P. Ry. Co. Survey, in Midland County. The tract is in the Azalea (Strawn) gas field in such county and the well was sought as an exception, on the ground of confiscation only,[1] to the Commission's statewide density order and special field rules which prohibit the drilling of a gas well on less acreage than a 640 acre proration unit.

Appellants Murphy H. Baxter, Joseph I. O'Neill, Jr. and Phillips Petroleum Company, owners of offset leases, intervened in the Trial Court and are aligned with the Commission.

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[1] Only legal confiscation as distinguished from factual confiscation as a result of drainage is involved here.

Upon a nonjury trial final judgment was rendered setting aside the order of the Commission and enjoining it from interfering with American in drilling the well in accordance with its application.

The validity of this judgment depends upon the existence of the 160-acre tract upon which the well was to be drilled as a separate tract prior to the time the 640-acre density rule of the Commission became applicable to the area in which the tract is located.

It is the contention of appellants that the 160-acre tract was subdivided (separated from a 320-acre tract) subsequent to the effective date of the density rule and hence such subdivision is illegal and will not support the sought for exception on the ground of confiscation.[2] This was also the ground upon which the Commission denied the permit to drill.

The facts which control the outcome of this appeal follow:

Section 29, supra, containing 640 acres of land was owned in fee in undivided interests by members of the Heidelberg family in September 1954. In September and November of that year American became the owner of the 7/8ths mineral leasehold estate in the section under eight oil and gas leases each lease covering an undivided interest in the entire section.

Since the execution of these leases there has been no change in the fee title to Sec. 29 or in the 1/8th royalty interest reserved by such leases.

On October 31, 1955, when statewide spacing Rule 37 provided regular twenty acre drilling units American and

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[2] The density rule applicable here incorporates the provisions of spacing Rule 37 of the Commission pertaining to the subdivision of property the effect of which is to disregard in determining the issue of confiscation any subdivision of property made after the spacing rule has become effective.

Murphy H. Baxter entered into an agreement whereby American agreed to assign to him, upon completion of a test well, certain leasehold interests including such interests in four alternate 80-acre portions of Section 29. Upon completion of such well assignments were made (March 29, 1956) as agreed and thereafter Baxter assigned certain undivided leasehold interests to various persons.

On November 1, 1956, Baxter and his assigns entered into an exchange assignment and agreement with American as a result of which the Baxter group became the owner of the leasehold interest covering the NE 4 and the SW 4 of Section 29 and American became the owner of the leasehold interest covering the NW 4 and the SE 4 of Section 29.

On November 12, 1956, American made a farm-out agreement with Joseph I. O'Neill, Jr., whereby O'Neill obligated himself to drill to completion a test well on the NW 4 of Section 30, Block 38, T-2-S, T. & P. Ry. Co. Survey, which agreement provided:

"Confirming our recent discussions, this letter will constitute our bottomhole agreement regarding a test well for oil and or gas which you hereby obligate yourself to drill at a well site located in ~~the approximate~~ center of the NW 4 of Section 30, Block 38, T-2-S, T. & P. Ry. Co. Survey, in Midland County, Texas, on a 160-acre tract of land which we are farming-out to you under this agreement.

"1. You agree to commence actual drilling at the above described well location on or before November 30, 1956, and to diligently continue the drilling of said well without interruption and in a good and workmanlike manner until you have drilled and tested to a total depth from the surface of at least 10,500 feet, unless you have established commercial production of oil and or gas, or have tested a conclusive volume of salt water, at a lesser depth in the Strawn (Pennsylvanian) Limestone formation. It is further understood and agreed that the drilling and completion of said well

shall be a firm obligation undertaken at your sole risk, cost and expense, and said well shall be completed either as a commercial producer or finally plugged and abandoned as a dry hole on or before March 1, 1957.

"2. Within fifteen (15) days after receipt and acceptance by us of final well data showing that the aforesaid well has been completed either as a commercial producer or finally plugged and abandoned as a dry hole, as herein provided, we agree to execute and deliver an assignment or assignments to you of all our rights, title and interest in and to the oil, gas and mineral leases on the following described tracts of land in Midland County, Texas, towit:

"The NW 4 and the SE 4 of Section 30, and the NW 4 and the SE 4 of Section 29, Block 38, Township 2 South, T & P RR Co. Survey, . . .

"The aforesaid assignment or assignments, and the delivery thereof to you, shall be subject to all of the terms and conditions of this agreement and of the basic leases concerned and will further provide that you shall pay all delay rentals which may thereafter become due under your portion of the above described oil and gas leases until such time as you shall give notice as provided in Paragraph 10 hereof of your intention to permit your portion of said leases to lapse in whole or in part and tender a reassignment to us;

"Save and except, that said assignment or assignments shall reserve unto Assignor, American Trading and Production Corporation, its successors and assigns, an overriding royalty of 3 8ths of 8 8ths of all the oil, gas and other minerals produced and saved from said lands under the terms of the basic leases or any renewals or extensions thereof, free of all costs, except taxes; and, save and except that the overriding royalty reserved unto Assignor on all the oil, gas and other minerals that may be obtained from any formation shallower than a total depth of 9,000 feet from the surface shall be reduced to 1 8th of 7 8ths of the total amount produced and saved by natural flow, and further shall be reduced to 1 16th of 7 8ths of the total amount produced and saved as to such portion or por-

tions of the total production as may be obtained by pumping or other artificial lifting methods.

"3. Furthermore, it is understood and agreed that within one hundred twenty (120) days after said first well has been drilled and completed either as a commercial producer or has been finally plugged and abandoned as a dry hole, as herein provided, you shall commence the actual drilling of a second test well on another of the four 160-acre tracts of land hereinabove described, and thereafter a third test well, and so on, with not more than one hundred twenty (120) days elapsing between the completion of one well and the commencement of another, until the above described tracts of land shall have been explored and developed to the density of one well to each 160 acres of land, more or less, all of which wells shall be drilled and tested in the same manner and to the same ultimate depth as herein set forth as regards the first test well;

"Provided, however, that should you fail to commence said second test well, or any subsequent test wells within the period of time allowed, you agree to forthwith reassign to us the oil, gas and mineral lease or leases on all of the remaining undeveloped 160-acre tracts of land hereinabove described, said reassignment to cover the full working interest under said tracts as originally assigned to you by us, retaining for yourself only each producing well and the 160 acres of land, more or less, surrounding such well. . . .

"In the event that you, or your successors or assigns, should elect to allow your portion of the above described oil and gas leases to lapse in whole or in part by the nonpayment of any delay rentals which may become due thereunder after you have acquired title thereto and before any commercial production has been established thereon, or, in the event that during the last year of the primary term of said lease you, or your successors or assigns, shall not be producing oil or gas from the above described lands, and should elect not to drill thereon and said oil and gas leases would thus expire and terminate by virtue of lack of production, then and in either of such events it is agreed that you, or your successors or assigns, at least

ninety (90) days before the due date of the next maturing delay rental or before expiration of the primary term of said leases, as the case may be, shall notify American Trading and Production Corporation in writing of your intentions to permit your portion of said leases to lapse or expire in whole or in part and shall tender to American Trading and Production Corporation for acceptance or rejection an assignment or assignments in the same form and with the same covenants as the assignment or assignments made by American Trading and Production Corporation covering the full interest under oil or such portion of the said oil and gas leases as would so lapse or expire."

In compliance with this agreement O'Neill drilled a test well on the NW 4 of Section 30 which was a dry hole.

Pursuant to its obligations under this agreement American on March 21, 1957 assigned to O'Neill the leases covering the NW 4 and SE 4 of Section 29. This assignment contained the following language:

"PROVIDED THAT in accordance with the terms and provisions of that certain farm-out agreement dated November 12, 1956, by and between assignee and assignor herein, assignee will drill or cause to be drilled a second, third and fourth well on said land in the manner and within the time intervals as set out in the aforesaid agreement. Should assignee fail to commence said second test well, or any subsequent test wells thereafter within the period of time prescribed in said farm-out agreement, then and in that event, assignee shall forfeit all rights, title and interest in and to the undeveloped acreage assigned herein and shall forthwith reassign to assignor the oil, gas and mineral leases on all the undeveloped acreage retaining only each producing well and 160 acres of land surrounding each producing well."

Subsequently, August 9, 1957, O'Neill completed a producing gas well on the SE 4 of Section 29. He was obligated, under his agreement, to commence an additional well within 120 days from August 9, 1957. This he did not do:

nor was such well commenced within a thirty day extension of time granted by American.[3]

On November 21, 1957, the Commission adopted field rules for the Azalea (Strawn) field in which the involved lands are located and prescribed a 640 acre proration unit.

On January 22, 1958, O'Neill, in accordance with the farm out agreement, reassigned to American the leases on three of the 160 acre tracts including the lease on the NW 4 of Section 29, O'Neill retaining the productive lease on the SE 4 of Section 29.

On May 6, 1958, American filed its application for a permit to drill on its reassigned lease covering the NW 4 of Section 29 and it is the action of the Commission in refusing this application that is the subject of this suit and appeal.

We sustain the action of the Commission. It is our opinion that O'Neill was vested with the title to the leasehold interests covering the SE 4 of Section 29 and the NW 4 of Section 29 when, on January 22, 1958, he conveyed by way of reassignment the leasehold interest covering the

[3] O'Neill's affidavit appears in the record and in it he states:

"that on December 6, 1957, affiant made a motion to the Texas Railroad Commisison for a rehearing in the matter of 640-acre proration units in the Azalea Field, which motion was denied by the Texas Railroad Commission on December 9, 1957;

"that affiant's sole purpose in requesting and obtaining such extension of time in which to commence said third well was to await the outcome of the aforementioned motion for rehearing, and that although affiant was desirous of drilling a well to test the Strawn Limestone formation located in the Northwest Quarter (NW/4) of Section 29, Block 38, T-2S, T & P Ry. Co. Survey, affiant was advised by counsel that it was impossible to do so under the existing field rules and in view of the Texas Railroad Commission's denial of the motion for rehearing; . . ."

NW/4 of Section 29 to American. This assignment constituted an illegal subdivision under the density rule then applicable to the area in which the land was located.

Our conclusion is based upon what we consider to be a proper construction of the farm-out agreement between American and O'Neill from which we have quoted herein.

The position of American is stated in its brief:

> " . . . appellee submits that the judgment of the Trial Court herein is correct because the NW 4 of Section 29 constitutes a 160-acre separate tract for oil and gas development, inasmuch as: (a) O'Neill did not acquire legal title to that tract, the letter agreement and the assignment of March 21, 1957, being in the nature of an option to O'Neill by which he could acquire legal title only if and when he completed a producing well thereon within the specified time-limit; . . .
>
> "In the language of the courts and the writers, the basic question to be determined is whether O'Neill's obligation to commence drilling each well within 120 days was a condition precedent, or a condition subsequent."

We construe the farm-out agreement as vesting in O'Neill title to the leasehold estates assigned to him upon completion of the first well subject to divestment upon nonperformance of the stated conditions. There are several rules, laid down by the courts, which have enabled, as well as required, us to reach this conclusion.

A deed will be construed to confer upon the grantee the greatest estate that the terms of the instrument will permit. Waters v. Ellis, 312 S.W. 2d 231, Supreme Court.

If the act does not necessarily precede the vesting of the estate, but may accompany or follow it; if this is to be collected from the whole instrument, the condition is subsequent. Bell County v. Alexander, 22 Tex. 351.

Where there have been other considerations performed or paid and the act in question is not the sole consideration

for the conveyance, a condition subsequent is imported. 12 Tex. Jur. 126, 127; Manton v. City of San Antonio, 207 S.W. 951, San Antonio CCA, writ ref.

Where the grantee is entitled to the possession and use of the property, a condition subsequent is implied. 4 Thompson on Real Property (Permanent Ed.) Sec. 2033, p. 557.

Applying these principles to the farm-out agreement it is evident that the agreement to drill wells two, three and four failing in which undeveloped tracts were to be reassigned to American emerges as a condition subsequent, which is a more favored estate than a condition precedent.

The delivery of the four leases, as provided in the farm-out agreement, was conditioned upon performance of the obligation to drill the first well. This was an extremely valuable consideration the record showing that the cost of drilling such well was approximately $200,000.00.

Upon the delivery of the lease assignments O'Neill was entitled to use and possession of the described premises for the purposes named in the leases.

Of course the act of drilling wells other than the first did not necessarily precede the vesting of the mineral estate conveyed by the lease assignments. The agreement specifically provided that such acts should follow at not more than 120 day intervals after delivery of the lease assignments.

Other matters which convince us that title vested in O'Neill when the lease assignments were delivered to him are (1) his obligation to pay rentals due under the assigned leases, which obligation is an incident of ownership (2) the provision in the farm-out agreement that in the event of reassignment by O'Neill "said reassignment to cover the full working interest under said tracts as originally assigned to you by us," and the provision of the agreement to reassign in the event the leases were about to expire be-

cause of non-payment of rentals or failure to develop that such reassignment should be "in the same form and with the same covenants as the assignment" made by American "covering the full interest under all or such portion of said oil and gas leases as would so lapse or expire" are consistent only with the ownership by O'Neill of the interests described in the assignments made by American to him.

We also consider the fact that the parties to the farm-out agreement clearly made the drilling of the first well a condition precedent to the acquisition of any title by O'Neill indicative of the fact that they deliberately and knowingly conveyed title to the four tracts after completion of the well and not a mere option for title as appellee contends.

Corroborative of this interpretation of the agreement is the language of the assignment executed pursuant to it which provided that should O'Neill fail to commence the second or any subsequent well that he should " . . . forfeit all rights, title and interest in and to the undeveloped acreage assigned herein and shall forthwith reassign the assignor the oil, gas and mineral leases on all the undeveloped acreage. . . . " This is a practical construction of the agreement by the parties and clearly connotes that O'Neill was vested with a title which was subject to forfeiture upon condition.

Appellee places principal reliance upon the case of Spinks v. First Christian Church of Vera, 273 S.W. 815, Tex. Comm. of App. The deed construed in this case was in the usual form of a conveyance with warranty of title but contained this provision:

> "It is agreed by and between the parties hereto that this conveyance is for the use and benefit of the said First Christian Church of Vera, Tex. It is further agreed and understood by and between the parties hereto that in event the said First Christian Church shall fail to erect upon said premises a church build

ing within 24 months from date of this deed, that then in that event the title to said premises shall revert to the said W. T. Ward, and this conveyance shall become null and void.

"And in event the said Christian Church shall erect said building within said time then in that event the title of the said First Christian Church in and to said tract of land shall become absolute."

In disposing of the case the court said:

"A deed must be construed by reading all of its provisions. They must be made to harmonize in all their provisions, wherever possible. Each clause must be given effect, unless inconsistent the one with the other. Now this deed to the Elders of the Christian Church was in the form of a general warranty deed, except for its provisions already quoted. . . . These provisions follow the granting clause and preceded the habendum and warranty clauses in the deed. Those conditional clauses constituted the very essence of the deed. They gave expression to the all controlling purpose of the grantor. Giving effect to this deed, as a whole, the condition was precedent rather than subsequent. . . .

"In other words, the deed was lying dormant until it should be vitalized and given life by the performance of this condition precedent. The deed merely gave to this church this right to acquire title to this lot by doing a certain thing beforehand. It required affirmative action to bring the deed into being. It was not a question of defeating a deed already in force, as must be true in a condition subsequent. . . .

"The deed, with its limitations, is very much like a general warranty deed, without limitations, left in escrow to be delivered upon certain conditions precedent. Unless those conditions be performed, the deed never becomes effective. No action on the part of the grantor in an escrow deed is necessary to regain his title, where there is a time limit as to when the conditions can be performed. . . .

"We realize that forfeitures of deeds are not favored, and that ordinarily they are construed most

strongly against the grantor. That is as it should be. But here we have a different case. We have a deed of gift. All the evidence shows that it was a gift. The giver has a right to fix his own conditions. He fixed but one. There was no effort on the part of the church to comply with it. . . .

"The net result of the ruling of the Court of Civil Appeals is that Ward is deprived forever of his property without having deceived the sole consideration expressed in the instrument by which he deeded it away. This is manifestly unjust. On the other hand, if the property reverted to Ward, the Christian Church was done no injustice whatever. They had spent nothing on the property. They had slept on their opportunity to acquire title to the land for church purposes. If the judgment of the Court of Civil Appeals is affirmed, the land will likely continue to be used by an individual, for private purposes, without paying compensation to any one therefor. Why should such a judgment be upheld?

". . .

"The parties to the instant deed made their intention perfectly clear. They had in mind no fanciful or technical distinctions about limitations or conditions subsequent. The church was given an option to acquire a 2-acre site by building a house of worship thereon within a certain time. If not so erected, the option would expire, and the trade would be at an end. This being without doubt the intention of the parties, that intention should be given effect."

It seems to us that the Court in Spinks in arriving at the intention of the parties which is the goal in the construction of all instruments was influenced most by the fact that the deed was a deed of gift the performance of the condition being the sole benefit contemplated by the grantor. Our case is, of course, distinguishable in that a very valuable consideration was paid by the grantee O'Neill for the lease assignments. It is also to be noted that in Spinks the deed provided that it should be a nullity if there was non-

performance of the condition. There is no similar provision in the farm-out agreement. See City of Dallas v. Ethridge, 152 Tex. 9, 253 S.W. 2d 640, where Spinks is distinguished. The conveyance there held to be upon condition subsequent is more similar in its terms to those of the farm-out agreement than the one construed in Spinks. The city was given use of the property conveyed and upon breach of stated conditions it was provided that the grantor should have the option to "terminate this grant." This language clearly implies the previous vesting of title and is very similar to the wording of the assignment here that upon violation of the stated conditions assignee should "forfeit all rights, title and interest," which language in our opinion clearly implies the previous vesting of title.

If it should appear, although it does not so appear to us, that the language of the farm-out agreement created a doubt as to the nature of the condition contained in it we would be duty bound to hold that it imposed a condition subsequent rather than a condition precedent. Davis v. Skipper, 125 Tex. 364, 83 S.W. 2d 318.

We turn now to the second and only remaining ground upon which American seeks to sustain the judgment below. This ground is stated as follows:

> " . . . the NW/4 of Section 29 was lawfully created as a separate 160-acre tract for oil and gas development on November 1, 1956, by the exchange assignment between Baxter et al. and appellee, and thereafter continuously remained a separate tract although it 'cornered' with the SE/4 of Section 29."

By the November 1, 1956, exchange agreement the Baxter group became the owner of the mineral leasehold on the NE 4 and the SE/4 of Section 29 and American became the owner of the mineral leasehold on the NW 4 and the SE 4 of Section 29.

It will be noted that the NW 4 and the SE 4 have but one point in common, that being the SE corner of the NW 4 and the NW corner of the SE 4.

Rule 2 of the Azalea (Strawn) Field Rules, adopted by the Commission November 21, 1957, provides, in part:

> "All such proration units shall consist of continuous and contiguous acreage which can reasonably be considered to be productive of gas."

American's contention here is that these two cornering quarter sections are not continuous and contiguous acreage because they have but a single point in common, a point being "an infinitesimal indication of a position having neither length, breadth or depth."

We are unable to agree with American on this construction of the rule.

Mr. Harry M. Batis, Chief Supervisor of the Oil and Gas Division of the Railroad Commission, testified that he had about fifteen years experience with the Commission in this field and that it had been the uniform practice of the Commission to consider cornering tracts to be "continuing and contiguous" within the meaning of the Commission rules and that there are thousands of fields having rules containing the same language.

It is appropriate to say here that O'Neill, American's assignor, so construed the rule as to the very same tracts. After completing a producing well on the SE 4 of Section 29 in August, 1957, he, on December 17, 1957, filed with the Commission a plat and affidavit designating the NW 4 and the SE 4 of Section 29 as a 320 acre proration for gas allowable purposes. This, of course, was prior to the assignment of the lease on the NW 4 to American on January 22, 1958.

It would not be difficult to imagine the confusion which would result in the industry if we were to adopt American's theory.

We believe the construction placed by the Commission on this rule is correct.

The following cases cited in Words and Phrases, Vol. IX, page 94 et seq. hold that tracts which touch only at corners are contiguous: Morris v. Gibson, 35 Ga. App. 689, 134 S.E. 796, Clements v. Crawford County Bank, 64 Ark. 7, 40 S.W. 133, Oregon Mortgage Co. v. Dunbar, 87 Mont. 603, 289 Pac. 559, and Parsons v. Dills, 172 Ky. 774, 189 S.W. 1158.

The same work Vol. IX, page 185 et seq. shows the definition of the word "continuous" as meaning: "connected, extended, or prolonged, without separation, or interruption, or interruption of sequence, unbroken, unintermitted" has been the subject of judicial approval many times.

We believe that these authorities along with definitions given the words "continuous" and "contiguous" by standard dictionaries as well as their commonly understood meaning demonstrate the correct interpretations of Rule 2, supra, by the Commission.

Whether we view the action of the Commission herein from a strictly legal point of view or whether we appraise it as being reasonable or arbitrary or whether we weigh it under the rule that the applicant for a permit to drill a test well for oil or gas must present a good faith claim for the permit we are convinced that the order of the Commission denying American's application to drill a test well on the NW 4 of Section 29, supra, was valid. So believing the judgment of the Trial Court is reversed and judgment is here rendered that American (appellee) take nothing by its suit or by reason of its appeal from the order of the Commission herein.

ROBERT C. HUGHES, *Associate Justice*

Reversed and Rendered
Filed: April 1, 1959.

Judgment of the District Court for the 53rd Judicial District of Texas, Travis County

IN THE DISTRICT COURT FOR THE 53RD JUDICIAL DISTRICT
OF TEXAS, TRAVIS COUNTY

No. 111,501

AMERICAN TRADING AND PRODUCTION CORPORATION

vs.

RAILROAD COMMISSION OF TEXAS, ET AL.

JUDGMENT

On this 22nd day of September, 1958, at a regular term of Court, the above cause came on regularly to be heard by the Court by agreement of all parties hereto, plaintiff, defendants, and intervenors, through their respective counsel of record, who filed herein and presented to the Court their joint motion and stipulation for the trial of this cause on its merits on this date; and the Court, having considered carefully the pleadings herein, the various stipulations of the parties, the evidence and testimony adduced, and the arguments of counsel, is of the opinion and finds that the factual allegations in the Original Petition of plaintiff herein are true, that the law and the facts are in favor of plaintiff, and that plaintiff is entitled to judgment against defendants as hereinafter provided:

It is therefore ORDERED, ADJUDGED, and DECREED by the Court that the order of the Railroad Commission of Texas and its Members, dated August 1, 1958, numbered 8-38,390 on Oil and Gas Docket No. 126, which denies the application of plaintiff, American Trading and Production Corporation, for a permit as an exception to Special Order No. 20-27,088 of the Railroad Commission, the applicable Density Order, to drill its Heidelberg No. 1 Well, Azalea (Strawn) Field, Midland County, Texas, at a regular location as permitted by the Spacing Rule applicable to

the Azalea (Strawn) Field, being 660 feet West of the East line and 660 feet North of the South line of the NW 4 of Section 29, Block 38, Township 2 South, T & P Railway Company Survey, Midland County, Texas, is hereby cancelled, set aside, and adjudged to be null and void; and that defendants, the Railroad Commission and its Members, agents, employees, and representatives, are hereby permanently enjoined and restrained from refusing to permit plaintiff, American Trading and Production Corporation, to drill said well upon said tract at said location, and from interfering with plaintiff, its agents, representatives, and employees, in the drilling and completion of said well and the production, storage, transportation, handling and marketing of oil and gas, or either, therefrom in compliance with existing valid oil and gas conservation laws, rules, and regulations; and all costs of suit are adjudged against defendants and intervenors, jointly and severally; and all relief which may be sought by the respective parties which is not specifically granted herein is hereby refused and denied.

The defendants and intervenors in open court thereupon excepted to the foregoing judgment of the Court, and gave notice of appeal to the Court of Civil Appeals for the Third Supreme Judicial District of Texas, sitting at Austin.

Signed and Ordered Filed this 24th day of September, 1958.

s/ Chas. O. Betts
Chas. O. Betts,
53rd Judicial District Court,
Presiding Judge of the
Travis County, Texas

Special Order of the Railroad Commission of Texas. Oil and Gas Division

RAILROAD COMMISSION OF TEXAS
OIL AND GAS DIVISION

Oil and Gas Docket No. 126

8-38,390

IN RE: CONSERVATION AND PREVENTION OF WASTE OF CRUDE PETROLEUM AND NATURAL GAS IN THE AZALEA (STRAWN) FIELD, MIDLAND COUNTY, TEXAS

Austin, Texas
August 1, 1958

SPECIAL ORDER

DENYING THE APPLICATION OF AMERICAN TRADING AND PRODUCTION CORPORATION FOR AN EXCEPTION TO SPECIAL ORDER NO. 20-27,086, THE APPLICABLE DENSITY ORDER, FOR ITS HEIDELBERG NO. 1 WELL, AZALEA (STRAWN) FIELD, MIDLAND COUNTY, TEXAS

WHEREAS, After due notice, the Railroad Commission of Texas held a hearing on May 27, 1958, to consider the application of American Trading and Production Corporation for an exception to the applicable density order, Special Order No. 20-27,088, for its Heidelberg No. 1 well, Azalea (Strawn) Field, Midland County, Texas; and

WHEREAS, The Railroad Commission of Texas, after due notice, hearing, and due consideration did promulgate and adopt in its Special Order No. 8-36,924, issued effective November 21, 1957, special rules to govern the drilling, completion, and operation of wells in the Azalea (Strawn) Field, wherein among other things, a unit rule prescribing a development pattern of one well to each 640 acres was established, said rules being adopted on a temporary basis to provide for orderly development and production practices pending the accumulation of additional data pertinent to approval of permanent rules; and

WHEREAS, From evidence adduced at the subject hearing, it appears to the Commission that the applicant seeks an exception to the density order, Special Order No. 20-27,088, which provides that no well shall be drilled on less acreage than that required in the pertinent proration unit rule; that the applicant seeks permission to drill on a 160 acre tract, being the N.W. 1/4 of Section 29, Block 38, Township 2 South, Midland County, Texas; that said tract is in fact a part of a basic 320-acre tract which includes both the N.W. 1/4 and S.E. 1/4 of Section 29; that said 320-acre tract has heretofore and is presently developed to density through the completion of the J. F. O'Neill, Jr. N. L. Heidelberg No. 1 well; that all of the acreage in the 320 acre tract may be allocated to the O'Neill well as continuous and contiguous acreage, as provided for in the unit rule heretofore mentioned; that no exception to the density order is necessary to protect the N.W. 1/4 of Section 29 from confiscation, but that in fact inequitable withdrawals of hydrocarbons would occur in favor of the 320-acre tract as compared to the offsetting tracts should a second well be authorized thereon; that said 320-acre tract existed as a single entity until it was subdivided by a reassignment in January, 1958 with subdivision was in violation of the density order; and

WHEREAS, From evidence adduced at said hearing, it further appeared to the Commission that the applicant contended, as it did in the field rule hearings, that waste would occur if a well were not permitted for the 160-acre tract; that the applicant's argument on waste prevention was the same as made at the rules hearings and that no additional evidence was made available that indicated said unit rule was adopted in error; and

WHEREAS, From the record made at said hearing, the Commission is of the opinion that said application for an exception to the density order should be denied because:

1. The identity of interest throughout the 320-acre tract existed until the reassignment was made by O'Neill to the applicant herein on January 22, 1958, causing subdivision in violation of density of that time.

2. The adoption of the unit rule and the attachment of the density order defeated O'Neill's right to drill a second well on such 320-acre tract, and granting said application would therefore allow circumvention of the legally adopted conservation regulation.

3. The waste prevention contention was directed at the rule adopted, and as such was a collateral attack on a valid order not in controversy in this cause, it being admitted by the applicant's witness that conditions throughout the reservoir are similar to conditions under the tract in question.

Now, Therefore, It Is Ordered By the Railroad Commission of Texas that effective July 7, 1958, the application of American Trading and Production Company for an exception to the density order, Special Order No. 20-27,088, for its Heidelberg Well No. 1, Azalea (Strawn) Field, Midland County, Texas, be and it is hereby denied.

It Is Further Ordered That this cause be held open on the docket for such other and further orders as may be necessary.

Railroad Commission of Texas
Chairman

Ernest O. Thompson
Commissioner

A. J. Murray, Jr.
Commissioner

(Seal)

Attest:

D. Hyndman
Secretary

FY:lb

APPENDIX D

Judgment of the Court of Civil Appeals, Third Supreme Judicial District of Texas at Austin

(Opinion of the Court of Civil Appeals which accompanied this Judgment is printed in Appendix C, *supra*, p. 11a).

Judgment Rendered April 1, 1959

No. 10,663

RAILROAD COMMISSION OF TEXAS, ET AL.

vs.

AMERICAN TRADING AND PRODUCTION CORPORATION

APPEAL FROM 53 DISTRICT COURT OF TRAVIS COUNTY
OPINION BY ASSOCIATE JUSTICE HUGHES

THIS CAUSE came on to be heard on the transcript of the record and same being inspected, because it is the opinion of the Court that there was error in the trial court's judgment, IT IS THEREFORE considered, adjudged and ordered that the judgment of the trial court be and same is hereby reversed and judgment is here rendered that the appellee take nothing by its suit or by reason of its appeal from the order of the Commission herein. IT IS FURTHER ordered that the appellee pay all costs in this behalf expended both in this Court and the court below and that this decision be certified below for observance.

ORDER MADE APRIL 22, 1959

OVERRULING APPELLEE'S MOTION FOR REHEARING

Motion = 12,125

Cause = 10,663

RAILROAD COMMISSION OF TEXAS, ET AL.

vs.

AMERICAN TRADING AND PRODUCTION CORPORATION

Appeal from 53 District Court of Travis County

Appellee's Motion for Rehearing

Motion is submitted and overruled.

FILE COPY

Supreme Court, U.S.
FILED
OCT 15 1959
JAMES R. BROWNING, Clerk

In the

Supreme Court of the United States

OCTOBER TERM, 1959

No. 387

AMERICAN TRADING AND PRODUCTION CORPORATION,
Petitioner,

v.

RAILROAD COMMISSION OF TEXAS, PHILLIPS PETROLEUM COMPANY, JOSEPH I. O'NEILL, JR.; AND MURPHY H. BAXTER,
Respondents.

BRIEF FOR RESPONDENTS IN OPPOSITION TO THE PETITION FOR A WRIT OF CERTIORARI

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INDEX

	Page
Questions Presented	1
Statute and Regulations Involved	2
Statement of the Case	3
Argument	9
1. Question not of general importance	9
2. There is no conflict with applicable decisions of this Court	11
3. The decision of the state courts was correct	13
4. No basis for suggested alternative disposition	24
Conclusion	25

Appendix A—Density Order	1a
Appendix B—Special Field Rules for Azalea (Strawn) Field	5a
Appendix C—Assignment from Petitioner to O'Neill	11a

Page

Cases

Brown v. Humble Oil & Refining Co., 126 Tex. 296, 83 S. W. 2d 935 (Tex. Sup. Ct.) 14

Brown v. Spilman, 155 U. S. 665 12

Burford v. Sun Oil Co., 319 U. S. 315 11, 15

California Reduction Co. v. Sanitary Works, 199 U. S. 306 18

Champlin Refining Co. v. Corporation Commission of Oklahoma, 286 U. S. 210 19, 21

Cities Service Gas Co. v. Peerless Oil & Gas Co., 340 U. S. 179 20, 21

Crowley v. Christensen, 137 U. S. 86 18

Gulf Land Co. v. Atlantic Refining Co., 134 Tex. 59, 131 S. W. 2d 73 (Tex. Sup. Ct.) 3, 4, 15, 19

Henderson v. Thompson, 300 U. S. 258 21

Lilly v. Conservation Commissioner of Louisiana, 29 F. Supp. 892 (E. D. La.) 13, 19

Lindsley v. Natural Carbonic Gas Co., 220 U. S. 61 21, 22

Nale v. Carroll, 155 Tex. 555, 289 S. W. 2d 743 (Tex. Sup. Ct.) 15

Ohio Oil Co. v. Indiana, 177 U. S. 190 12, 19, 20, 21

Patterson v. Stanolind Oil & Gas Co., 305 U. S. 376 19, 21

Pennsylvania Coal Co. v. Mahon, 260 U. S. 393 11, 12

Phillips Petroleum Co. v. State of Oklahoma, 340 U. S. 190 21

Railroad Commission of Texas v. Humble Oil & Refining Co., 151 Tex. 51, 245 S. W. 2d 488 (Tex. Sup. Ct.) 23

Railroad Commission v. Magnolia Petroleum Co., 130 Tex. 484, 109 S. W. 2d 967 (Tex. Sup. Ct.) 11

Railroad Commission of Texas v. Rowan & Nichols Oil Co., 310 U. S. 573 20, 21

	Page
Ryan Consolidated Petroleum Corporation v. Pickens, 155 Tex. 221, 285 S. W. 2d 201 (Tex. Sup. Ct.)	24
Sun Oil Co. v. Railroad Commission, 68 S. W. 2d 609 (Tex. Civ. App.)	14, 18
Texas Co. v. Railroad Commission of Texas, 246 S. W. 2d 487 (Tex. Civ. App.)	23
Texas Trading Co. v. Stanolind Oil & Gas Co., 161 S. W. 2d 1046 (Tex. Civ. App.)	18
Thompson v. Consolidated Gas Utilities Corp., 300 U. S. 55	11, 12
Thompson v. Spear, 91 F. 2d 430 (Fifth Cir.)	22
United States v. Central Eureka Mining Co., 357 U. S. 155	12
Walls v. Midland Carbon Co., 254 U. S. 300	21, 22

Constitutional Provisions

Texas Constitution, Art. XVI, § 54a	3

Regulations

Density order	2, 6, 15, 16, 21
Field Rules for Azalea (Strawn) Field	2, 5, 6, 16, 17, 21
Order denying exception to petitioner	6, 16, 21
Rule against subdivisions (Rule of May 29)	4, 11, 15, 16
Rule 37	3, 10, 14, 15, 16, 23

Miscellaneous

16A C. J. S., § 571, p. 588	19
31 Tex. Jur. 706-7	3
31-A Tex. Jur. 602, 604-5, 611-13	3
31-A Tex. Jur. 672	3
31-A Tex. Jur. 677, 706	3
31-A Tex. Jur. 709	4

In the

Supreme Court of the United States

OCTOBER TERM, 1959

No. 387

AMERICAN TRADING AND PRODUCTION CORPORATION,
Petitioner,

v.

RAILROAD COMMISSION OF TEXAS, PHILLIPS PETROLEUM COMPANY, JOSEPH I. O'NEILL, JR., AND MURPHY H. BAXTER,
Respondents.

BRIEF FOR RESPONDENTS IN OPPOSITION TO THE PETITION FOR A WRIT OF CERTIORARI

QUESTIONS PRESENTED

Respondents re-state the questions presented for review:

1. Whether, under the particular facts and conveyances and admittedly-valid regulations involved in this case, the state regulatory commission acted arbitrarily, in violation of the due process clause or the equal protection clause of the Fourteenth Amendment, by

ruling, after full hearing, that the 160-acre tract was a part of the larger 320-acre basic lease or tract on the effective date of the field rules and that petitioner was therefore not entitled to a permit for a second well on such 320-acre basic lease or tract?

2. Whether, under the facts of this particular case, the Commission's denial of an exception to the admittedly-valid density rule deprived petitioner of its property without due process of law in violation of the Fourteenth Amendment?

3. Whether, under the facts of this particular case, the Commission's denial of an exception to the admittedly-valid density rule denied to petitioner the equal protection of the laws in violation of the Fourteenth Amendment?

STATUTE AND REGULATIONS INVOLVED

Although the statute and the two regulations listed in the petition are "involved" in this case, the *validity* of such statute and regulations is not in question. The only order under attack is the State Commission's order denying petitioner's application for an exception to the density rule. Petition, Appendix C, p. 28a. Other regulations involved are:

(1) The Commission's statewide density order, adopted August 28, 1953 (S. F. 13, 116).[1] Printed in Appendix A, p. 1a, *infra*.

(2) The Commission's special order adopting field rules for the Azalea (Strawn) Field effective November 21, 1957 (S. F. 13, 60, 108, 122). Printed in Appendix B, p. 5a, *infra*.

[1]References marked "S. F." are to the Statement of Facts volume and those marked "Tr." are to the Transcript volume from the district court.

STATEMENT OF THE CASE

The Railroad Commission of Texas has been regulating the spacing of oil and gas wells since 1919[2] and its statewide spacing rule and the related subdivision rule have been upheld repeatedly by the courts.[3]

The subdivision rule is essential to the preservation of the spacing rule itself as a necessary preventative of circumvention of the rule.[4]

While the statewide spacing rule and many special field rules prescribe the location of wells in terms of minimum *distances*, the density rule adopted by the Commission in 1953 regulates the spacing of wells in terms of *acreage* and prohibits drilling on "less acreage than that required for a standard proration unit as established in the applicable rules for any oil or gas field in the State of Texas." Appendix A, p. 1a, *infra*. This rule, like the general subdivision rule, requires, for an exception, a showing that the basic lease containing less acreage than that prescribed for

---

[2] *31-A Tex. Jur. 672.* The Constitution of the State of Texas, by a provision adopted in 1917 (Article XVI, §59a), declared the conservation and development of the state's natural resources to be public rights and duties and directed the State Legislature to pass laws appropriate thereto. Comprehensive oil and gas conservation statutes have been enacted and amended from time to time, and the administration of such measures has been committed to the Railroad Commission of Texas. *31-A Tex. Jur. 602, 604-5, 611-3.*

[3] *Gulf Land Co. v. Atlantic Refining Co., 134 Tex. 59, 131 S. W. 2d 73 (1939); 31-A Tex. Jur. 677, 706.*

[4] *31-A Tex. Jur. 706-7.*

[5] Petition, Appendix A, p. 6a.

a standard proration unit has not been subdivided from a larger tract.[6]

The particular fact situation involved in this case is evidenced primarily by written instruments. In September, 1954, the Heidelberg family owned fee simple title to a 640-acre section of land identified as Section 29; and in September and November of that year such landowners executed oil and gas leases, each covering the entire section, to petitioner (S. F. 2, 8, 65-72). Petitioner thereby acquired the right to drill for and produce oil and gas from the entire section and became the owner of an undivided ⅞ interest in the oil and gas in place under the entire section, subject to the lease provisions. There has been no subsequent change in or subdivision of the surface estate or the oil and gas royalty interest, and the landowners were and still are entitled to receive ⅛ of all oil and gas produced from the entire 640-acre section regardless of the quarter-section or other portion of the section on which a well may be located.[7]

In 1955 and 1956, petitioner and respondent Baxter and his assigns made certain assignments and agreements which resulted in Baxter and his assigns acquiring the ⅞ leasehold interest in 320 acres of Section 29 (NE/4 and SW 4[8] and in their drilling a producing well thereon, petitioner

[6]Appendix A, p. 1a, *infra*. "No owner of lands which can be developed as a whole under the conservation laws of the state and the valid rules of the Commission in force at the time he undertakes to do so can by his voluntary acts divide the same into small tracts by severance of the minerals, lease or otherwise, and thus create in himself, or in any assignee or vendee under him any vested right in any exception to the conservation rules of the Commission which would enable him to circumvent the conservation laws and valid rules of the Commission designed to make such laws effective." *31-A Tex. Jur. 709; see Gulf Land Co. v. Atlantic Refining Co.*, supra, footnote 3.

[7]The landowners are not parties to this case, and their rights are not involved.

[8]Abbreviations refer to quarter-sections, e.g. NE/4 means the Northeast Quarter of the section.

retaining the 7/8 leasehold interest in the remaining 320 acres of said section (NW/4 and SE/4) (S. F. 2-3, 9-10, 73-75).

By farmout letter agreement of November 12, 1956 (S. F. 3, 10, 76), and by assignment of March 21, 1957 (S. F. 5, 10, 88, printed as Appendix C, p. 11a, *infra*), petitioner assigned and conveyed to respondent O'Neill an undivided 4/8 leasehold interest in petitioner's remaining 320 acres of said section, reserving, however, an undivided 3/8 of all oil and gas produced and saved therefrom as an overriding royalty free of costs. This assignment provided for drilling to a density of one well to each 160 acres and for forfeiture and re-assignment of undeveloped acreage in the event of failure to drill to such density.

On August 9, 1957, O'Neill completed a producing well on such 320-acre lease, the well being located in the SE/4 of the section. The time for commencement of O'Neill's next well (420 days) was to expire on December 7, 1957 (S. F. 31); but petitioner extended such time to January 6, 1958 (S. F. 5, 60, 128).

On November 21, 1957,[1] the Railroad Commission adopted special field rules for the Azalea (Strawn) Field in which Section 29 is situated (S. F. 13, 108, printed as Appendix B, p. 5a, *infra*). Rule 1 of such field rules permits only one well to each 640-acre proration unit and provides that in applying this rule the general order of the Commission with relation to subdivision of property shall be observed. Rule 2 prescribes 640-acre proration units. Rule 3 provides for

[1] The formal order is dated December 19, 1957, effective November 21, 1957 (S. F. 108-9). Informal memorandum was issued to all operators on November 21, 1957 (S. F. 122).

allocation of allowable production on a formula of ⅔ acreage and ⅓ per well.

Since the adoption of the above field rules precluded his drilling a second well on his 320-acre tract, O'Neill, on January 22, 1958, re-assigned his interest in the NW ¼ of the section to petitioner, retaining, however, his interest in the SE ¼ of the section and the producing well located thereon (S. F. 5, 11, 95-99). After such re-assignment, petitioner still owned and had the right to receive, as an overriding royalty, ⅜ of all oil and gas produced and saved from the SE ¼ of the section but owned the entire ⅞ working interest in the NW ¼ of the section.

In May, 1958, petitioner filed with the Commission its application to drill a well on the NW ¼ of the section, and a hearing was held on such application (S. F. 6, 11, 100). The Commission, in its order of August 1, 1958, found and determined, after hearing, that the NW ¼ of the section was in fact a part of a basic 320-acre tract which included both the NW ¼ and the SE ¼ of the section and that said 320-acre tract existed as a single entity until it was subdivided by re-assignment in January, 1958, which subdivision was in violation of the density order, and that petitioner's application to drill a second well on such 320-acre tract should be denied (S. F. 6, 12, 102).[10]

When the Azalea (Strawn) field rules became effective and the density rule became applicable to Section 29 on November 21, 1957, two producing gas wells had already

[10]The order is printed in Petition, Appendix C, p. 28a.

been lawfully drilled on that section: the Baxter well located in the NE/4, and the O'Neill well located in the SE/4 (S. F. 2-3). Pursuant to such rules, the 320-acre basic tract owned by Baxter (NE 4 and SW 4) was allocated to the Baxter well, and the 320-acre basic tract owned by O'Neill (SE 4 and NW 4) was allocated to the O'Neill well (S. F. 60, 61, 121, 125). The Railroad Commission has consistently treated the proration unit on which the O'Neill well is located as containing and including the entire 320 acres (SE 4 and NW 4) and has allocated the entire 320 acres to the O'Neill well in fixing its allowable under the proration formula (½ acreage, ½ per well). Petitioner, as owner of ⅜ of all of the oil and gas produced from the O'Neill well free of costs, has accepted and received and is still accepting and receiving and enjoying the benefit of its oil and gas interest in the entire 320-acre tract and the benefit of the allowable production from the O'Neill well based upon acreage credit for the entire 320 acres, including the NW/4 (S. F. 43-44).

No evidence whatever was introduced as to the nature or extent of the reservoir, drainage or any other condition which would tend to show that the Commission's order denying the exception would result in confiscation of petitioner's property or that petitioner would not receive its fair share of the oil and gas by production from the O'Neill well. It was stipulated in the trial court that petitioner does not contend that it is entitled to a permit under the waste-prevention exception (S. F. 7).

After respondents had given notice of appeal from the trial court's judgment setting aside the order, petitioner,

with full knowledge that an appeal was being taken, drilled a well on the NW/4 of Section 29 and dually completed same as a producer from both the Strawn formation and the Devonian formation. Since no field rules had been adopted for the Devonian formation, petitioner's right to drill to and produce from the Devonian formation is not questioned. For several months, until the mandate of the Court of Civil Appeals was issued, petitioner produced gas and condensate from the Strawn formation at high rates of production, while at the same time receiving 3/8 of the production from the O'Neill well which was and still is receiving allowable credit for the same 160 acres on which petitioner's well is located.

In the state courts petitioner contended (1) that the transactions and assignments between petitioner and Baxter resulted in subdivision of the section into four 160-acre tracts and separated the NW/4 from the SE/4 (even though the ownership of these two quarter-sections remained common); and (2) that the farmout letter and assignment from petitioner to O'Neill and the drilling of the O'Neill well vested title to the SE/4 in O'Neill but did not convey to O'Neill any title to the NW/4 because the drilling of a well on that quarter-section was a condition precedent (as distinguished from a condition subsequent). The state courts overruled both of these contentions,[11] and apparently petitioner has now abandoned them.

The statement on page 6 of the Petition that the SE/4 of the section on which the O'Neill well is located is "not

[11]See opinion of Court of Civil Appeals printed in Petition, Appendix C, p. 11a.

involved here" is inaccurate in that the entire 320-acre tract, including the SE/4, has been held to be one basic lease or tract.

In connection with petitioner's statement that the allowable production was apportioned among the "other" well owners in the field (Petition, p. 9), attention is invited to the facts that (1) a proportionate part of the field allowable for the Strawn formation was and is apportioned to the O'Neill well and petitioner receives 3/8 of the production from such well, and (2) petitioner's well receives its share of the field allowable for the Devonian formation.

ARGUMENT

The petition should be denied for each and all of the reasons hereinafter stated and argued:

1. Question Not of General Importance

The issue involved here, whether the facts of this particular case entitle petitioner to an exception to admittedly-valid regulations adopted pursuant to admittedly-valid state statutes, is not of general importance. The decision of the state courts was based on the facts of this particular case and the particular instruments involved.

Petitioner's contentions seeking to establish the importance of this case simply have no support in the record. There is, for instance, no evidence whatsoever that the type of "farm out" arrangement here involved is used by ranchers and small property owners to obtain development of their property by operators who are financially able to

drill wells and are willing to take the risks. (Petition, p. 2.) To one familiar with the industry, the contrary is usually true, as was the case here—a substantial operator with large holdings in the area seeks to have its properties evaluated by "farming out" a part of its acreage to a small operator or individual who is willing to drill a test well to acquire an interest in the potential gas or oil field. There is no evidence in the record that the particular arrangement used here by petitioner constituted a typical "farm out" assignment. The assignment from petitioner to O'Neill (Appendix C, p. 11a, *infra*) clearly shows that it was devised for this particular transaction, as distinguished from being in common and general use. There is likewise no evidence that the denial by the Railroad Commission of an exception so that petitioner might drill a second well on the basic 320-acre tract merely because it owned an inchoate right of re-entry in the NW 4 will have any effect whatsoever on mineral interests in general or the use of "farm out" agreements to promote development. The fact that the use of "farm out" assignments continues to be so widespread despite the denial of similar applications for exceptions to Rule 37 since the subdivision rule was adopted in 1934 establishes that this case cannot have the drastic impact feared by petitioner.

This case involves merely one specific transaction, and there is no more reason for this Court to review it than there is for reviewing any of the other myriad of situations and contracts which the state courts and the Railroad Commission have held to be in violation of the rule against

subdivision when exceptions to allow the drilling of additional wells on the basic tract are sought.[12]

Viewed in its proper perspective, this case involves merely the denial of an exception to drill one well (actually a second well on a basic proration unit) out of nearly 200,000 wells in the State of Texas to a single geological formation, the Strawn Sand. Petitioner's right to drill to all other formations has not been questioned, and it is in fact now producing this very well from the Devonian formation. Furthermore, petitioner has received and is receiving and accepting its 3/8 overriding interest from the Strawn well already located on the proration unit based upon its increased allowable for 320 acres.

2. There is No Conflict With Applicable Decisions of This Court

Petitioner relies on the cases of *Pennsylvania Coal Co. v. Mahon, 260 U. S. 393 (1922)*, and *Thompson v. Consolidated Gas Utilities Corp., 300 U. S. 55 (1937)*, to establish the asserted conflict.

The *Mahon* case held invalid, "so far as it affects the mining of coal under streets or cities where the right to mine such coal has been reserved" (p. 414), a statute which prohibited the mining of coal beneath streets and cities where the ownership of the coal and the ownership of the surface estate had been separated. The facts showed that the deed separating such ownership was executed in 1878 and the statute was enacted in 1921. There is no indication

[12] As early as 1943, this Court recognized the voluminous litigation which arises over applications for exceptions to Rule 37, companion rule to the density order involved here. See *Burford v. Sun Oil Co., 319 U. S. 315, 324.*

that the same holding would prevail if the ownership of the coal and of the surface were segregated after enactment of the statute. In this case, petitioner had actual knowledge or was charged with knowledge of the density order and the rule against subdivision when the various instruments were executed.

The *Mahon* case itself recognizes that whether a particular governmental restriction amounts to a constitutional taking is a question properly turning upon the particular facts of each case.[13] This Court has never cited that case as authority where a state regulation involving the conservation and protection of its natural resources, much less a fugacious resource like gas and oil, was at issue. On the contrary, it has long been recognized that decisions in ordinary cases of mining for coal and other minerals which have a fixed situs cannot be applied without qualification to contracts concerning gas and oil. *Ohio Oil Co. v. Indiana, 177 U. S. 190 (1900)*, citing *Brown v. Spilman, 155 U. S. 665 (1895)*.

Thompson v. Consolidated Gas Utilities Corp., 300 U. S. 55 (1937), merely held that the state could not arbitrarily restrict the production of one who had a market for his gas and could produce it without waste to force that party to share the capacity of its pipe line (not a common carrier) with other operators who had no pipe line outlet for their gas. That case has no factual relationship whatsoever to the present case and no more serves to establish a conflict than any of hundreds of other cases which held that con-

[13] See also *United States v. Central Eureka Mining Co., 357 U. S. 155, 168 (1958)*.

stitutional rights were violated. The citation of such cases merely begs the real question—whether the denial of an exception to admittedly-valid rules and regulations to drill the second well on a basic proration unit was so arbitrary and unreasonable as to be beyond the scope of the police power of the state in the conservation and protection of its natural resources.

Respondents again point out that petitioner's property and mineral interest in the 160-acre tract has not been confiscated or taken. Its right to drill a second well on a proration unit to a single formation has been lawfully restrained under valid rules and regulations, the purpose of which is to prevent waste of the reservoir energy by the drilling of unnecessary wells and to protect the rights of all owners in the common source of supply.[11] Petitioner is receiving and accepting its 3/8 overriding royalty interest in the one well already drilled to the Strawn formation on the 320-acre tract and there is no testimony that this will not yield to petitioner its fair share of the gas in the Strawn reservoir. Petitioner can drill on the 160-acre tract to any other formation and has drilled and is producing this very well in the Devonian formation.

The decision of the state courts presents no conflict with applicable decisions of this Court which would warrant review.

3. The Decision of the State Courts Was Correct

In any event the petition should be denied because the decision of the Court of Civil Appeals, from which writ of

[11] See discussion in *Lilly v. Conservation Commissioner of Louisiana*, 29 F. Supp. 892, 897 (E. D. La. 1939).

error was refused by the Supreme Court of Texas, was patently correct under applicable decisions of this Court and granting certiorari would only result in affirmance.

a. *Denial of such exceptions to drill additional wells is vital to State Conservation Program.*

The State of Texas has adopted and followed since 1919 a comprehensive plan of regulation governing the drilling, spacing and production of oil and gas wells. This system of regulation has been so extensively discussed in litigation in both state and federal courts over the years that it may be said to be a matter of judicial knowledge.[15]

"Wildcat" wells which discover a new field and the first few wells drilled thereafter in the field are regulated by what are known as the "statewide" rules and regulations of the Railroad Commission. One of these rules is "Rule 37" which prescribes minimum distances between wells and from property lines. This rule was adopted in 1919 and has been in existence in varying forms since that date. Its purpose is to prevent waste caused by the drilling of unnecessary wells, which would result in dissipation of the reservoir energy which alone causes the gas or oil to move through the rock formation and to the surface in the well bore, and to protect the correlative rights of the owners in the common source of supply. The rule is necessary to assure that oil and gas fields are drilled in an orderly and

[15] *Railroad Commission v. Magnolia Petroleum Co., 130 Tex. 484, 109 S. W. 2d 967 (1937); Brown v. Humble Oil & Refining Co., 126 Tex. 296, 83 S. W. 2d 935 (1935); Sun Oil Co. v. Railroad Commission, 68 S. W. 2d 609 (Tex. Civ. App. 1933).*

scientific manner and is vital to the entire integrated conservation program.[16]

Because Rule 37, prescribing minimum distances that wells must be located from property lines, could not be effectively administered so long as it was possible to subdivide property at will for the purpose of creating new tracts, the Railroad Commission in 1934 adopted the rule against subdivisions, which is often called the Rule of May 29, from the date of its adoption. (This rule is quoted at Appendix A, p. 6a of the Petition.) The effect of the rule against subdivisions is sometimes misunderstood. Like all rules and regulations of the Railroad Commission, it does not purport to effect a change or transfer of property rights.[17] It merely states that any subdivision of a tract occurring after Rule 37 attaches shall be disregarded and only the basic tract shall be considered in determining whether that tract is entitled to *additional* wells to prevent confiscation.[18]

Because the Railroad Commission often adopts a distance rule for a field which does not require the well to be located in the exact center of the proration unit (to permit flexibility because of surface obstructions, etc.), the Commission on August 28, 1953, adopted the Statewide Density Order. Its purpose was to prevent the drilling of more than one well on a proration unit, contrary to the intent of the Commission, where such additional drilling was technically

[16] *Gulf Land Co. v. Atlantic Refining Co., 134 Tex. 59, 131 S. W. 2d 73, 80 (1939); Burford v. Sun Oil Co., 319 U. S. 315, 323-324 (1943).*

[17] *Nale v. Carroll, 155 Tex. 555, 289 S. W. 2d 743, 745 (1956).*

[18] *Gulf Land Co. v. Atlantic Refining Co., 134 Tex. 59, 131 S. W. 2d 73, 82-83 (1939).*

permissible under the distance rule (see findings in the order, p. 1a, which is quoted in full as Appendix A, *infra*).

Effective November 21, 1957, the Railroad Commission adopted special field rules for the Azalea (Strawn) Field. The rules affected only the Strawn formation and no other geological zone. These rules (the pertinent provisions of which are set forth as Appendix B, p. 5a, *infra*) provide for spacing of 2640 feet between wells on the same lease and 660 feet from any property line; proration units of 640 acres plus 10% tolerance; and allocation of production on the basis of ⅔ acreage and ⅓ to the individual well. The order specifically provides that only one well shall be drilled on each 640-acre proration unit and that the rule regarding subdivision of property shall be observed (p. 7a). By its own terms, the Statewide Density Order attached when these special field rules were adopted. All of these occurrences were prior to the conveyance from O'Neill to petitioner dated January 22, 1958.

Because O'Neill was vested with title to the oil and gas leasehold interest in the basic 320-acre unit on the date field rules were adopted and on the date he conveyed the 160-acre NW/4 to petitioner, the Railroad Commission and the state courts held that this effected an "illegal" (meaning in violation of the rule against subdivisions) subdivision and denied petitioner an exception to the density order. The effect of this ruling was that the 320-acre

tract must be treated as a unit, and having one well located thereon, it was not entitled to a second well.[19]

Having abandoned its tenaciously held contention that title to the NW/4 *never* passed to O'Neill, petitioner now argues that a contract right reserved in the assignment from petitioner to O'Neill dated March 21, 1957 (whose pertinent provisions are set forth as Appendix C, p. 11a, *infra*), required the Commission to grant it an exception. The argument is that because the instrument of March 21, 1957, executed before the adoption of special field rules and in conformity with statewide rules, required the drilling of one well to each 160 acres, petitioner thereupon acquired a vested right to drill one well to each 160 acres which rendered the Railroad Commission powerless to adopt any other spacing or proration unit rule applicable to petitioner. The statewide rules, applicable to newly drilled areas until special field rules are adopted, permit the drilling of one well to each 20 acres. If petitioner's argument were valid, it could have contracted for the drilling of one well to each 20 acres and thereby established such rights superior to any action by the Commission in the exercise of its statutory duties to prevent waste and to protect the correlative rights of all operators. More important and more alarming, however, is that if petitioner were to prevail in its contention, every other operator in Texas could, and many no doubt would, execute similar contracts to fix and establish their own views and desires regarding

[19] The 320-acre tract, although only half as large as the standard proration unit prescribed by the field rules, was entitled to one (but only one) well because it existed as a separate tract before the adoption of field rules.

spacing and the size of proration units to the complete frustration of the Commission's powers and duties in the field of conservation. It is for this very reason that the Texas courts have long held that a mere contract (as distinguished from actual drilling and completion of a well in compliance with the then existing rule) cannot vest rights in spacing rules in derogation of the Commission's powers. *Texas Trading Co. v. Stanolind Oil & Gas Co.*, 161 S. W. 2d 1046, 1047 (Tex. Civ. App. 1942, error ref. w.m.); *Sun Oil Co. v. Railroad Commission*, 68 S. W. 2d 609, 613 (Tex. Civ. App. 1933). It is difficult to imagine the chaos in the exercise of the police power which would result if the rule were otherwise. This Court has held many times that contract and property rights are held subject to reasonable exercise of the police power. *California Reduction Co. v. Sanitary Works*, 199 U. S. 306 (1905); *Crowley v. Christensen*, 137 U. S. 86 (1890).

b. *Due process.* Petitioner states the question in this part of its petition as to whether its property was taken without compensation. The actual issue of course is whether the denial of the exception, under admittedly-valid statutes and regulations enacted under the police power of the state, deprived petitioner of its property without due process of law.

Petitioner has been deprived of no property—it has the same right, title and interest it always had. The use of the property has been restricted to the extent that drilling a second well on a basic proration unit to one particular geological formation is precluded.

The guaranty of due process does not prevent the exercise of police power, provided such exercise is reasonable and not arbitrary, the law is for a public purpose, and the means selected have a real and substantial relation to the object sought to be obtained. *16A C. J. S.*, § *571, p. 588.*

Contrary to petitioner's argument (Petition, p. 22), the regulation of the spacing of wells and the denial of exceptions sought for additional drilling on subdivisions effected after the adoption of field rules do have a vital and legitimate relationship to conservation. Otherwise, it would be impossible to promote the orderly and scientific development of fields. *Gulf Land Co. v. Atlantic Refining Co., 134 Tex. 59, 131 S. W. 2d 73, 80 (1939).* Such regulation is necessary to limit the number of wells to be drilled and to prevent the drilling of unnecessary wells to conserve the reservoir energy which brings the production to the surface and the exhaustion of which delimits the life of the field. See discussion, *Lilly v. Conservation Commissioner of Louisiana, 29 F. Supp. 892, 897 (E. D. La. 1939).* This is a legitimate exercise of the police power in the interest of conservation, as this Court has held on many occasions. *Patterson v. Standard Oil & Gas Co., 305 U. S. 376 (1939); Champlin Refining Co. v. Corporation Commission of Oklahoma, 286 U. S. 210 (1932); Ohio Oil Co. v. Indiana, 177 U. S. 190 (1900).*

Petitioner's argument that the Commission's action does not prevent waste because it does not require a reduction in the total amount of gas production from the field (Petition, p. 22) is wholly without merit, being relevant, if at

all, only to economic waste and having nothing to do with physical waste resulting from unrestricted drilling.

Likewise irrelevant is the argument (Petition, pp. 22-23) that the Commission's action cannot be justified as a means of protecting the neighboring owners of gas and oil from disproportionate withdrawals from the common reservoir by petitioner (and for that matter, by any other operator who might so subdivide his property) because the Commission has the authority to reduce the amount of gas and oil taken from a small tract. This argument evades the real question of whether what the Commission did do was a reasonable exercise of its power, because the question of which of several methods of regulation to achieve a legitimate end should be adopted is solely within the province of the Commission. As this Court said in *Cities Service Gas Co. v. Peerless Oil & Gas Co., 340 U. S. 179, 186 (1950)*:

> "It is no concern of ours that other regulatory devices might be more appropriate, or that less extensive measures might suffice. Such matters are the province of the legislature and the Commission."

To the same effect, that the wisdom of regulation and the method which should be chosen is for the regulatory authority and that the courts should not be dominated by their own conception of the fairness and reasonableness of the order in judging the validity of a conservation order under the Fourteenth Amendment, are *Railroad Commission of Texas v. Rowan & Nichols Oil Co., 310 U. S. 573 (1940)*; *Ohio Oil Co. v. Indiana, 177 U. S. 190 (1900)*.

The action in denying petitioner the exception to drill a second well on the basic 320-acre proration unit was a reasonable exercise of the police power and therefore no more deprived petitioner of its property without due process of law than countless other state conservation statutes and regulations which have been upheld by this Court against similar attack. Typical of such cases are *Ohio Oil Co. v. Indiana, 177 U. S. 190 (1900); Lindsley v. Natural Carbonic Gas Co., 220 U. S. 61 (1911); Walls v. Midland Carbon Co., 254 U. S. 300 (1920); Champlin Refining Co. v. Corporation Commission of Oklahoma, 286 U. S. 210 (1932); Henderson Co. v. Thompson, 300 U. S. 258 (1937); Patterson v. Stanolind Oil & Gas Co., 305 U. S. 376 (1939); Railroad Commission of Texas v. Rowan & Nichols Oil Co., 310 U. S. 573 (1940); Cities Service Gas Co. v. Peerless Oil & Gas Co., 340 U. S. 179 (1950); Phillips Petroleum Co. v. State of Oklahoma, 340 U. S. 190 (1950).*

The Railroad Commission and the State courts held that O'Neill was vested with the leasehold title to both the NW 4 and the SE 4 of the section on the date field rules were adopted and that the subsequent conveyance to petitioner was in violation of the density order and the rule against subdivisions. Whatever petitioner may choose to call its future right under the assignment to O'Neill, it most assuredly did not have title. The State action in looking to the title is a reasonable and necessary classification to enforce orderly development in the field and to prevent emasculation of spacing rules by the splitting of estates into numerous and varied future and contingent interests, each carry-

ing with it the vested right to drill to whatever density may be desired by the creators. A classification such as this, having a reasonable basis in fact to achieve a legitimate end, is not discrimination in violation of constitutional guaranties. *Lindsley v. Natural Carbonic Gas Co., 220 U. S. 61 (1911); Walls v. Midland Carbon Co., 254 U. S. 300 (1920); Thompson v. Spear, 91 F. 2d 430 (Fifth Cir. 1937), cert. den. 302 U. S. 762.*

Finally, the facts of this particular case as to the resulting effect on all of petitioner's interests as a whole in the *entire* property (and not merely an isolated inchoate right in a selected portion of the land) must be considered in determining the reasonableness of the exercise of the police power. Petitioner has been and is now receiving and accepting its 3/8 overriding royalty interest in the well on the 320-acre unit based upon its increased allowable, and there is no evidence in the record that this will not produce petitioner's fair share of the gas in the Strawn formation. Furthermore, petitioner has not been restricted in drilling to any other formation on the NW/4 and in fact has drilled a well and is now producing from the Devonian formation.

c. Equal protection.

Most of petitioner's arguments relating to this issue are dealt with in the preceding section of this brief on the due process question. Such challenges to state regulatory action are usually on both grounds and a decision that the regulation is a reasonable exercise of the police power, as

respondents believe has been heretofore established, is ordinarily decisive of both questions.

Respondents do wish to deal briefly with the implication that petitioner was somehow treated differently by the Railroad Commission than other applicants for exceptions. There is no evidence that any applicant similarly situated to petitioner has ever been granted such an exception. Neither is there any evidence of "the established practice of the Commission" as asserted on page 26 of the petition; petitioner's assertion that it has found only two cases involving such a "practice" carries its own refutation. In fact, however, the two cases cited by petitioner, *Railroad Commission of Texas v. Humble Oil & Refining Co., 151 Tex. 51, 245 S. W. 2d 488 (1952)*, and *Texas Co. v. Railroad Commission of Texas, 246 S. W. 2d 487 (Tex. Civ. App. 1952)*, (Petition, fn. 4, 8, 26; pp. 5, 7, 26-27), are readily distinguishable. There was not "complete identity of ownership as to everything except a very small fraction of the royalty interest," as asserted by petitioner (Petition, p. 7); an undivided one-fourth of the fee simple mineral title was under different ownership in each case. In each case, the fee interest was subdivided before Rule 37 was applicable to the tract, and not afterward as the leasehold interest was in this case.

The consistency of the Railroad Commission's policy in ruling on applications for exceptions such as petitioner's is illustrated by the case of *Ryan Consolidated Petroleum Corporation v. Pickens, 155 Tex. 221, 285 S. W. 2d 201*

(Tex. Sup. Ct. 1955), cert. den. 351 U. S. 933. In that case, the complaining party, who had been denied an exception to drill on his two lots, owned *no* interest in and received *no* part of the production from the well on the other two lots, the four lots together constituting the basic proration unit recognized by the Railroad Commission. Nevertheless, the Texas courts upheld the order denying an exception and this Court denied certiorari.

Petitioner's concluding arguments on page 27 of the petition simply assume the points it seeks to establish. Petitioner did not have a "substantial and important property interest" or a "substantial mineral interest" on the date field rules were adopted. It had only an inchoate, contingent interest which could ripen only if O'Neill failed to drill, and O'Neill had the entire leasehold title. The Commission's action, in considering the unity of ownership of the leasehold title in the 320-acre tract on the date field rules were adopted in passing upon petitioner's subsequent application for an exception to permit drilling to a greater density than that found by the Commission to be in the interest of conservation for the field, was a valid exercise of the police power under the principles heretofore discussed.

4. No Basis for Suggested Alternative Disposition

Since the alternative disposition suggested by petitioner presupposes granting a writ of certiorari, the suggestion is fully answered by the foregoing argument. Furthermore, the holding of the Court of Civil Appeals that the Commission's order was not unreasonable or arbitrary, to-

gether with the overruling of petitioner's motion for rehearing and refusal of the application for writ of error, show that the questions presented have been considered by the state courts. (Petition, pp. 11-12; Appendix C, p. 25a.) Remand for reconsideration would only cause delay, after which review by this Court would again be sought.

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be denied.

Respectfully submitted,

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October 9, 1959.

APPENDIX A

WELL DENSITIES IN FIELDS WITH SPECIAL RULES

Special Order No. 20-27,088, Pertaining to Well Densities in All Fields Where Standard Proration Units Have Been Established in Special Field Rules, Effective August 28, 1953.

WHEREAS, The Commission, after due notice and hearing, has adopted rules and regulations concerning the development of and production of oil and gas from the various oil and gas fields in the State of Texas; and

WHEREAS, The Commission has adopted such rules and regulations only after considering the evidence adduced at hearings specifically called for that purpose, wherein it was shown that there was necessity for the adoption of standard spacing and proration unit rules as a waste prevention measure; and

WHEREAS, The rules were adopted so that such oil and gas fields would be subjected to a more orderly development, but the rules were so written that under certain conditions a basic lease or unitized tract could be developed to a greater density than one well to each standard proration unit, which, all things considered, was contrary to the intent and purpose of such standard spacing and proration unit rules; and

WHEREAS, The Commission authorized spacing rules at variance with true central location of a well to each proration unit for the purpose of allowing an operator some

flexibility in the location of a well without the necessity for seeking an exception to the applicable rule, and not for the purpose of allowing greater density of development than was contemplated in adoption of the spacing and proration unit rules; and

WHEREAS, The Commission is of the opinion that the apparent conflict between the actual meaning and the possible interpretation of the rules as adopted should be rectified.

NOW, THEREFORE, IT IS ORDERED By the Railroad Commission of Texas that no well shall be drilled on less acreage than that required for a standard proration unit as established in the applicable rules for any oil or gas field in the State of Texas except as hereinafter provided.

A permit to drill a well for oil or gas on a proration unit containing less acreage than the standard proration unit for such field shall not be granted, unless the operator seeking such permit submits to the Commission in affidavit form the necessary data to show that such permit is needed to develop a basic lease or unitized tract to its final density, or that the basic lease or unitized tract of land contains less total acreage than that prescribed for a standard proration unit, and that such basic lease or unitized tract containing insufficient acreage has not been subdivided from a larger tract; provided that, if after drilling of the last well on a basic lease or unitized tract and the assignment of acreage to each well thereon in accordance with the applicable field rules, there remains additional unassigned acreage, then and in such event an operator may assign such additional

acreage in accordance with the tolerance provision of the applicable proration unit rule, provided, however, that if such remaining additional unassigned acreage is less than the amount specified in the rules for tolerance purposes the total unassigned acreage must be utilized as tolerance acreage and assigned as such to the well or wells already drilled on the basic lease or unitized tract.

IT IS FURTHER PROVIDED THAT in any field where the total unassigned acreage can be utilized as tolerance acreage and assigned to wells already drilled on a basic lease or unitized tract that such is hereby required even though a regular location can be made on such acreage.

* * * * *

IT IS FURTHER ORDERED That a Form 1 (Notice of Intention to Drill or Deepen) shall be accompanied by a certified basic lease or unitized tract plat showing thereon the acreage dedicated to the proration unit for the proposed well, and also showing thereon the acreage previously dedicated to all Commission approved well locations on said basic lease or unitized tract, and further, that a permit to drill any well for oil or gas will not be granted until such plat has been attached to and made a part of such Form 1. Each operator seeking a permit to drill on a basic lease or unitized tract containing insufficient acreage must file with and as a part of his Form 1, the names and addresses of all offsetting property owners, and must attest thereon that such basic lease or unitized tract has not been subdivided from any other tract. If further proof is desired by the Commission, a hearing may be called.

IT IS PROVIDED HOWEVER, That the Commission, in order to prevent waste or to prevent the confiscation of property, may grant exceptions to the density provisions as stated above. Such an exception will be granted only after notice and hearing.

IT IS FURTHER ORDERED That after a unitized tract, wherein two or more separate tracts are joined for oil or gas development purposes, has been accepted by the Commission, it may not thereafter be subdivided into its original separate tracts unless and until approval for such subdivision is granted by the Commission after notice and hearing...

IT IS FURTHER ORDERED That this cause be held open on the docket for such other and further orders as may be necessary.

APPENDIX B

December 19, 1957

SPECIAL ORDER ADOPTING RULES AND REGULATIONS FOR THE AZALEA (STRAWN) FIELD, MIDLAND COUNTY, TEXAS

WHEREAS, After due notice, the Railroad Commission of Texas held hearings on June 26, 1957, and September 23, 1957, on the application of Murray H. Baxter to consider the adoption of rules and regulations to govern the drilling, completion and operation of wells in the Azalea (Strawn) Field, Midland County, Texas; and

WHEREAS, From evidence adduced at said hearings, it appears to the Commission that the subject field was discovered in March of 1956, and is presently developed with 5 wells; that the producing reservoir is the Strawn formation found in the approximate interval from 7609 feet subsea to 7785 feet subsea; that there is evidence of lensing of porosity in the formation with the reservoir rock having a very low order of permeability and porosity in the range of 1 md permeability and 8% to 10% porosity; that the reservoir is a retrograde condensation type that is rich with fluids; that testimony of the several technical witnesses indicate that reservoir data presently available is insufficient for a conclusive determination of the proper development pattern, but that such data does show the need for establishment of regulation to provide orderly development and production practices in the field; that

additional data concerning reservoir performance is necessary before a final conclusion or proper unit size can be reached in this matter; that temporary rules are necessary pending the accumulation of additional data; and

WHEREAS, from evidence submitted at said hearing, the Commission is of the opinion and finds that waste as the term is defined in the applicable statutes will take place in said field unless temporary rules are adopted by the Commission for the prevention thereof, and that the following field rules are necessary to prevent such waste and to provide for a more orderly development and operation of said field.

NOW, THEREFORE, IT IS ORDERED By the Railroad Commission of Texas that effective November 21, 1957, the following rules in addition to such of the Commission's general rules and regulations as are not in conflict herewith, be and the same are hereby adopted to govern the drilling, completion and operation of wells in the Azalea (Strawn) Field, Midland County, Texas.

RULE 1: No gas well shall hereafter be drilled nearer than two thousand six hundred forty (2640) feet to any well completed in or drilling to the same reservoir on the same lease, unitized tract or farm, and no well shall be drilled nearer than six hundred sixty (660) feet to any property line, lease line or subdivision line, provided, however, that the Commission will, in order to prevent waste or to prevent the confiscation of property, grant exceptions to permit drilling within shorter distances than herein

prescribed whenever the Commission shall have determined that such exceptions are necessary either to prevent waste or to prevent the confiscation of property. When exception to this rule is desired, application therefor shall be filed and will be acted upon in accordance with the provisions of Commission Statewide Rules 37 and 38, which applicable provisions of said rules are incorporated herein by reference.

The aforementioned distances in the above rule are minimum distances to allow an operator flexibility in locating a well, and the above spacing rule and the other rule to follow are for the purpose of permitting only one well to each six hundred forty (640) acre proration unit.

In applying this rule the general order of the Commission with relation to the subdivision of property shall be observed.

RULE 2: The acreage assigned an individual non-associated gas well for the purpose of allocating allowable gas production thereto shall be known as a gas proration unit, and such acreage may be claimed for each non-associated gas reservoir independently of any other reservoir. No gas proration unit shall contain more than six hundred forty (640) acres except as hereinafter provided; and no acreage shall be included in any proration unit formed or created subsequent to the effective date of this order and allocated to the well thereon unless the most distant boundary of such acreage shown to be included in such unit is within fifty-two hundred eighty (5280) feet of such well; provided that

tolerance acreage of ten (10) percent shall be allowed for each unit so that an amount not to exceed a maximum of seven hundred four (704) acres may be assigned, and each unit containing less than six hundred forty (640) acres shall be a fractional proration unit. All such proration units shall consist of continuous and contiguous acreage which can reasonably be considered to be productive of gas.

Operators shall file with the Commission certified plats of their properties in said field, which plats shall set out distinctly all of those things pertinent to the determination of the acreage credit claimed for each well; provided that if the acreage assigned to any proration unit has been pooled, the operator shall furnish the Commission with such proof as it may require as evidence that interests in and under such proration unit have been so pooled.

RULE 3: The daily allowable production of gas from individual wells completed in a non-associated gas reservoir of the subject field shall be determined by allocating the allowable production, after deductions have been made for wells which are incapable of producing their gas allowables, among the individual wells in the following manner:

(a) Two-thirds ($\frac{2}{3}$) of the allowed gas production from a non-associated gas reservoir shall be allocated to the individual wells completed therein in the proportion that the acreage assigned to each such well bears to the sum of the acreage in the reservoir.

(b) One-third ($\frac{1}{3}$) of the allowed gas production from a non-associated gas reservoir shall be allocated equally among the individual wells completed therein.

(c) The total daily non-associated gas allowable for each well shall be the sum of its acreage and per well allowables.

* * * * *

IT IS FURTHER ORDERED That this cause be held open on the docket for such other and further orders as may be necessary.

APPENDIX C

ASSIGNMENT OF OIL AND GAS LEASES

WHEREAS, on the 15th day of November, 1949, a certain oil, gas and mineral lease was made and entered into by and between N. A. Brooks and wife, Callie Brooks, Lessors, and American Trading and Production Corporation, Lessee, covering the following-described land in Midland County, Texas, to-wit:

> The West Half (W 2) of Section 28 and the South Half (S 2) of Section 30, Block 38, Township 2 South, T. & P. RR. Co. Survey

said lease containing 654 acres, more or less, and being recorded in Volume 114, pages 522-5 of the Deed Records of said County, and

WHEREAS, on the 9th day of February, 1950, a certain oil, gas and mineral lease was made and entered into by and between N. A. Brooks and wife, Callie Brooks, Lessors, and American Trading and Production Corporation, Lessee, covering the following-described land in Midland County, Texas, to-wit:

> All of the North Half (N 2) of Section 30, Block 38, Township 2 South, T. & P. RR. Co. Survey

said lease containing 327 acres, more or less, and being recorded in Volume 116, pages 638-41 of the Deed Records of said County, and

WHEREAS, on the 8th day of September, 1954, certain oil, gas and mineral leases were made and entered into by and between Woody Heidelberg and wife, Eugenia Heidel-

berg, W. A. Dunn and wife, Mona Dunn, M. E. Henry and wife, Alta Henry, Nathan Heidelberg and wife, Velma Heidelberg, J. W. Heidelberg and wife, Stella Heidelberg, Leo J. Schindler and wife, Cora Schindler, and Joe Heidelberg and wife, Lulian Heidelberg, Lessors, and American Trading and Production Corporation, Lessee; and on the 30th day of November, 1951, a certain oil, gas and mineral lease was made and entered into by and between Adah D. Heidelberg, Guardian of the Estate of Vernon Holton Heidelberg, a person of unsound mind, Lessor, and American Trading and Production Corporation, Lessee, all of which leases cover the following-described land in Midland County, Texas, to-wit:

All of Section 29, Block 38, Township 2 South, T. & P. RR. Co. Survey

said leases containing 640 acres, more or less, and being recorded in Volume 219 on pages 170-175, Volume 220, page 407, Volume 221, page 514, and Volume 223, page 508, and

WHEREAS, all of the said described oil and gas leases and all rights thereunder or incident thereto are now owned by American Trading and Production Corporation, a Maryland corporation, insofar as said leases cover the land hereinafter described and assigned;

NOW, THEREFORE, for and in consideration of the sum of One Dollar ($1.00) and other good and valuable considerations, the receipt of which is hereby acknowledged, the undersigned, the present owner of said oil and gas leases as aforesaid, and all rights thereunder or inci-

dent thereto, does bargain, sell, transfer and convey all its rights, title and interest in and to said oil and gas leases and all rights thereunder or incident thereto insofar and only insofar as said oil and gas leases cover the following-described tracts of land, to-wit:

a. The West Half (W 2) of the North Half (N 2) of Section 30, Block 38, Township 2 South, T & P RR Co. Survey;

b. The East Half (E 2) of the South Half (S 2) of Section 30, Block 38, Township 2 South, T & P RR Co. Survey;

c. The West Half (W 2) of the North Half (N 2) of Section 29, Block 38, Township 2 South, T & P RR Co. Survey;

d. The East Half (E 2) of the South Half (S 2) of Section 29, Block 38, Township 2 South, T & P RR Co. Survey;

but not including any personal property now on said land or used or obtained in connection therewith, to JOSEPH I. O'NEILL, JR., his heirs, successors and assigns;

SAVE AND EXCEPT that assignor herein specifically reserves unto itself, its successors and assigns, an overriding royalty interest of 3 8ths of 8 8ths of all the oil, gas condensate or distillate, and other minerals produced and saved from said land under the terms and conditions of the basic leases or any renewals or extensions thereof, free of all costs except taxes, and except that the overriding royalty reserved on all of the oil, gas, condensate or distillate, and other minerals that may be produced from a depth of less than 9000 feet below the surface shall be reduced to

1/8th of 7/8ths of the total amount produced and saved by natural flow and to 1/16th of 7/8ths of the total amount produced and saved as to such portion or portions of the total production as may be obtained by pumping or other artificial lifting methods.

PROVIDED THAT in accordance with the terms and provisions of that certain farmout agreement dated November 12, 1956, by and between assignee and assignor herein, assignee will drill or cause to be drilled a second, third and fourth well on said land in the manner and within the time intervals as set out in the aforesaid agreement. Should assignee fail to commence said second test well, or any subsequent test wells thereafter within the period of time prescribed in said farmout agreement, then and in that event, assignee shall forfeit all rights, title and interest in and to the undeveloped acreage assigned herein and shall forthwith reassign to assignor the oil, gas and mineral leases on all the undeveloped acreage retaining only each producing well and 160 acres of land surrounding each producing well.

TO HAVE AND TO HOLD said leases as aforesaid and all rights and privileges thereunder or incident thereto, only to the extent above specified, unto the said JOSEPH I. O'NEILL, JR., his heirs, successors and assigns, in accordance with the terms and provisions thereof, it being specifically understood and agreed that JOSEPH I. O'NEILL, JR., his heirs, successors and assigns, shall pay all delay rentals which may become due hereafter except that in the event the said JOSEPH I. O'NEILL, JR., his

heirs, successors or assigns should elect to allow his portion of the above-described oil and gas leases or any part of them to lapse by non-payment of any delay rentals which may become due thereunder after the said JOSEPH I. O'NEILL, JR. has acquired title thereto and before any commercial production has been established thereon, or in the event that during the last year of the primary term of said leases JOSEPH I. O'NEILL, JR., his heirs, successors or assigns, shall not be producing oil or gas from the above-described tracts and should elect not to drill thereon and his portion of said oil and gas leases would thus expire and terminate by virtue of lack of production, then and in either of such events, it is agreed that said JOSEPH I. O'NEILL, JR., his heirs, successors or assigns, shall, at least ninety (90) days before the due date of the next maturing delay rental or before expiration of the primary term of his portion of said leases, as the case may be, notify American Trading and Production Corporation in writing of his intention to permit said leases to lapse or expire and shall tender to American Trading and Production Corporation for acceptance or rejection an assignment in the same form and with the same covenants as the assignment made by American Trading and Production Corporation covering the full interest under all or such portion of said oil and gas leases as would so lapse or expire.

This assignment is made without warranty of any kind, either express or implied, except that American Trading and Production Corporation is the lawful owner of the above described oil, gas and mineral leases and whatever

rights and interest may be granted thereby, and that all rentals due and payable under said leases have been duly paid. Assignee herein, by acceptance of this assignment, assumes all of the obligations of said leases insofar and only insofar as they cover the tracts of land hereinabove described and to the extent specified.

IN WITNESS WHEREOF, the undersigned owner and assignor has signed this instrument this 21st day of March, 1957.

AMERICAN TRADING AND
PRODUCTION CORPORATION

IN THE

Supreme Court of the United States

OCTOBER TERM, 1959

No. 387

AMERICAN TRADING AND PRODUCTION CORPORATION,
Petitioner

v.

RAILROAD COMMISSION OF TEXAS, PHILLIPS PETROLEUM COMPANY, JOSEPH I. O'NEILL, JR., AND MURPHY H. BAXTER, *Respondents*

REPLY TO BRIEF OF RESPONDENTS IN OPPOSITION TO THE PETITION FOR A WRIT OF CERTIORARI

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1. *Importance of the Question.*—Respondents admit that farm-out assignments are widespread (Resp. Br., p. 10). While they assert that there is "no evidence in the record" that the transaction between petitioner and O'Neill constituted a typical farm-out assignment (Resp. Br., p. 10), they admit that under this assignment O'Neill acquired the present right to drill—i.e., the leasehold "title"—while petitioner retained a royalty interest and the right to regain the property if O'Neill failed to drill (Resp. Br., p. 5). This is the most common form of farm-out. See Breeding and Burton, Taxation of Oil and Gas Income, §§ 2.04 and 7.02. Exactly similar interests arise from

every lease of a gas and oil property. Summers on Oil and Gas §§ 391-410 and 553. The retained interest denied protection in this case is no different than those created by virtually every lease or farm-out (sublease) transaction in Texas.

The everyday importance and common use of these interests in protecting lessors and sublessors against failure, by their lessees or sublessees, to develop gas and oil properties is recognized by leading authorities.[1] The right to regain the drilling interest in gas and oil properties because of a failure to drill has been recognized and enforced by the Texas courts[2] and by this Court.[3]

Respondents make it clear that the Railroad Commission protects only the holders of a *present right to drill* against confiscation through new spacing rules, and that holders of other interests, including retained interests such as that held by petitioner, are denied protection (Resp. Br., pp. 21-22). The decision of the Court below upholding the Commission will have the effect of making retained interests illusory. Under this decision the lessor who retains the right to recover gas and oil properties if the lessee fails to drill can at the option of the Railroad Commission be left with an

[1] See 1A Summers on Oil and Gas § 151 (the commonplace function of gas and oil leases); §§ 391-410 (retained interests created by the covenants in gas and oil leases); 3 Summers on Oil and Gas § 553 (commonplace function of "farm-out" assignments); and § 554 at page 652 (retained interests created by the covenants in farm-out assignments).

[2] *Perkins* v. *Mitchell*, 153 Tex. 368, 268 S.W. 2d 907 (1954); *Waggoner Estate* v. *Sigler Oil Co.*, 118 Tex. 509, 19 S.W. 2d 27 (1929).

[3] *Sauder* v. *Mid-Continent Petroleum Corp.*, 292 U.S. 272 (19

empty and valueless title. Such a decision clearly impairs the utility and value of these widespread and frequently used retained rights.

2. *Impeding the Commission.*—Respondents claim (Resp. Br., pp. 17-18) that "frustration" and "chaos" would result if petitioner's interest were protected. They contend that petitioner argues it "acquired a vested right to drill one well to each 160 acres which rendered the Railroad Commission powerless to adopt any other spacing or proration unit rule." (Resp. Br., p. 17). They assert that "if petitioner's argument were valid, it could have contracted for the drilling of one well to each 20 acres and thereby established such rights superior to any action by the Commission in the exercise of its statutory duties to prevent waste and protect the correlative rights of all operators." (Resp. Br., p. 17). Moreover, they assert, every other operator in Texas could do the same.

Petitioner has never in any stage of this proceeding claimed that it has a vested right with respect to the spacing of wells on the Northwest quarter. What petitioner has contended and now contends is simply that the Northwest quarter must be treated as a separate and distinct tract from the Southeast quarter because petitioner had a retained interest in the Northwest quarter which it did not have in the Southeast quarter. The two tracts differed in ownership, and petitioner has contended and now contends that it is entitled to have one well on its separate tract in order to produce the gas and oil thereunder before it is removed by others.

Whether petitioner—or other persons in petitioner's position—could drill one well or several wells on the

tract is governed not by the farm-out agreement but by the Commission's spacing regulations. There is no dispute that in the present case the spacing rules in effect when petitioner applied for its permit would allow the drilling of only one well on the Northwest quarter. No hypothetical agreement between petitioner and O'Neill to drill one well on each 20 acres could possibly have changed this situation and required the Railroad Commission to permit the drilling of more than one well. Whatever the size of the tract that returns by virtue of a retained interest, and whatever the agreement between the parties, the tract that returns is entitled to only one well if, as here, it is smaller than the established spacing unit. However, this *one* well is essential in order to prevent confiscation of the retained interest. The Railroad Commission cannot constitutionally wipe out such interests by looking only to the present right to drill and ignoring all other property rights.

In seeking the one additional well necessary to protect its retained interests, petitioner has merely sought the only means provided by the Texas system for protection of holders of small tracts against confiscation of their gas and oil. Under the Texas system, such protection is provided only by granting permission to drill a well on each separate tract, however small.[4] See Hardwicke, "Oil Well Spacing Regulations and Protection of Private Property Rights in Texas," 31 Tex.

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[4] When this suit was tried in the District Court, the Proration Schedule showed that 8 of the 9 wells in the Azalea (Strawn) Field had been drilled on tracts smaller than the 640 acre minimum well-spacing unit. In the case of 4 wells, the acreage was half or less of the required 640 acres. Defendant's Exhibit 2, R. 125-27. (References marked "R" are to the Statement of Facts volume in the District Court.)

L. Rev. 99 (1952). This obviously results in the drilling of vastly more wells than necessary for effective drainage of the minerals in a given gas and oil reservoir. For this reason, this system has been replaced, in nearly every other state concerned with regulating gas and oil production, by a system which compels owners of small tracts to "pool" their tracts together and remove the minerals through a single, jointly operated well. See Hardwicke, *supra*.

Texas has persisted in the "one well for each tract—however small" approach, to the point that separate wells were recently allowed on tracts only .48 acre and .625 acre in size. *Halbouty* v. *Darsey*, 326 S.W. 2d 528 (Tex. Civ. App. 1959); *Foster* v. *Railroad Commission*, 326 S.W. 2d 533 (Tex. Civ. App. 1959) (writ of error refused in both cases by Texas Supreme Court, Oct. 14, 1959). The petitioner does not argue that the State of Texas has no right to use its present system in preference to adopting a more modern system such as compulsory pooling, which would avoid the waste incident to the present Texas procedure. As correctly pointed out by the respondents (Resp. Br., p. 20), the wisdom of the State's choice is not a matter of concern in this case. The fact remains, however, that the State must in some way protect the property of each landowner whenever well-spacing is regulated. So long as Texas retains its present cumbersome system of extending such protection, it cannot complain that some extra wells will be required for the protection of retained interests in addition to the great number required for protection of present drilling interests.

3. *Petitioner's Injury.*—Respondents repeatedly call attention to petitioner's royalty interest in the well on

O'Neill's neighboring Southeast quarter.[5] They treat this as somehow eliminating the injury caused by the Commission's refusal of a well on the Northwest quarter (Resp. Br., pp. 9, 11, 13, 22). Over petitioner's vigorous objection, repeated in the District Court (R. 44-46), the respondent Railroad Commission has granted the respondent O'Neill the same allowable to which he would have been entitled if he owned the Northwest quarter.[6] This indirectly results in a slight increase in the amount petitioner received from its royalty interest in O'Neill's well. However, the fact that petitioner has thus had thrust upon it a very small increase in its revenue from one tract, in which it has a royalty interest, does not justify the Commission in entirely depriving it of its much more substantial property interest in an entirely different tract.

Respondents also call attention to the fact that petitioner's well on the Northwest quarter is producing from the Devonian horizon, a reservoir about 1,000 feet deeper than the Strawn horizon (Resp. Br., pp. 9, 11, 13, 22).[7] Under Texas law, the property rights in different reservoirs are separate and distinct; there is

[5] This royalty interest arise from the farm-out transaction, as pointed out in the Petition for Certiorari (p. 6).

[6] The respondents do not contend that the Commission's action below purported to effect a change or transfer of property rights; to the contrary respondents admit that petitioner owns the entire working interest in the Northwest quarter (Resp. Br., pp. 6, 15).

[7] The existence of this production is not shown by any evidence on the record but is not disputed by petitioner. What the respondents fail to disclose is that the Devonian has practically no commercial value—a fact which is well known to the respondent Phillips, which has purchased all of the gas and oil produced from this well, and to the respondent Railroad Commission which has received reports each month on the quantities of gas and oil produced from the Devonian.

no relationship between the rights to produce from different formations, even though they may be reached through the same well hole. Respondents admit petitioner has a separate right in each reservoir, the Strawn and the Devonian. (Resp. Br., p. 8.) The fact that it continues to produce from the Devonian does not erase the fact that it has been completely deprived of its property right in the Strawn reservoir, and that the gas and oil attributable to its tract has been divided among the respondents O'Neill, Baxter, and Phillips and the other operators in the field.

Respectfully submitted,

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